

1 KAMALA D. HARRIS  
Attorney General of California  
2 MARTIN GOYETTE (SBN 118344)  
Senior Assistant Attorney General  
3 DANETTE E. VALDEZ (SBN 141780)  
Supervising Deputy Attorney General  
4 FREDERICK W. ACKER (SBN 208109)  
CLARENCE BINNINGER (SBN 190015)  
5 ANNADEL A. ALMENDRAS (SBN 192064)  
SYLVIA W. KELLER (SBN 197612)  
6 MYUNG J. PARK (SBN 210866)  
KENNETH J. SUGARMAN (SBN 195059)  
7 LUCY F. WANG (SBN 199772)  
EMILY C. KALANITHI (SBN 256972)  
8 Deputy Attorneys General  
455 Golden Gate Avenue, Suite 11000  
9 San Francisco, CA 94102-7004  
Telephone: (415) 703-5608  
10 Fax: (415) 703-5480  
E-mail: Rick.Acker@doj.ca.gov

11 *Attorneys for the People of the State of California*

12 SUPERIOR COURT OF THE STATE OF CALIFORNIA

13 COUNTY OF SAN FRANCISCO

14  
15  
16 **PEOPLE OF THE STATE OF  
CALIFORNIA,**

17 Plaintiff,

18 v.

19  
20 **THE MCGRAW-HILL COMPANIES,  
INC., STANDARD & POOR'S  
21 FINANCIAL SERVICES LLC, AND DOES  
1-100,**

22 Defendants.  
23

Case No.

**COMPLAINT FOR TREBLE DAMAGES,  
CIVIL PENALTIES AND PERMANENT  
INJUNCTION FOR VIOLATION OF  
THE CALIFORNIA FALSE CLAIMS  
ACT, UNFAIR COMPETITION LAW,  
AND FALSE ADVERTISING LAW**

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1 The People of the State of California, by and through Kamala D. Harris, Attorney General  
2 of the State of California, based on information and belief, bring this action against The McGraw-  
3 Hill Companies, Inc. and Standard & Poor's Financial Services LLC (collectively "S&P").

## 4 INTRODUCTION

5 1. In the years leading up to the 2007-08 financial crisis, S&P intentionally inflated  
6 its ratings of structured finance securities, costing California's public pension funds and other  
7 investors hundreds of billions of dollars when those overrated securities later collapsed. S&P  
8 purported to be a neutral gatekeeper of the financial markets, dispensing impartial ratings on tens  
9 of thousands of complex, opaque securities. Investors, including California's public pension  
10 funds, relied on S&P's integrity and its ratings. That reliance turned out to be misplaced. In  
11 reality, S&P corrupted its ratings process to curry favor with large banks, which paid S&P  
12 billions of dollars in return. In other words, S&P claimed to be a gatekeeper, but it acted like a  
13 toll collector.

### 14 I. S&P'S CLAIMS ABOUT ITSELF AND ITS RATINGS

15 2. S&P made many specific claims to investors and the general public about how it  
16 ran its business. For example, S&P promised that the fees it collected from banks and other  
17 security issuers would never affect the ratings it gave those securities. It represented that it had  
18 impenetrable ethical walls protecting the S&P analysts who rated structured finance securities  
19 from pressure due to "an existing or a potential business relationship between [S&P] . . . and the  
20 issuer." Issuer fees, S&P promised, could "not be a factor in the decision to rate an issuer or in  
21 the analysis and the rating opinion."

22 3. S&P also advertised the purported reliability and high quality of its ratings. It  
23 claimed, for instance, that an AAA rating meant that a security had an "[e]xtremely strong  
24 capacity to meet financial commitments." An AAA-rated security was, according to S&P, safer  
25 than all but a small handful of the very highest quality corporate bonds – as secure as U.S.  
26 Treasury bonds.

1 **II. INVESTORS, INCLUDING CALIFORNIA'S PUBLIC PENSION FUNDS, RELIED ON S&P'S**  
2 **RATINGS**

3 4. S&P's ratings played a crucial role in the worldwide market for structured finance  
4 securities for a number of reasons. Among the most important, S&P was in a position to know –  
5 and did know – far more about these securities than investors, such as California's public pension  
6 funds. For example, all of the securities relevant to this case were issued by pass-through  
7 vehicles that depended entirely on income from portfolios of assets. Investors did not know what  
8 assets were in the portfolios held by those vehicles. That information was considered confidential  
9 by the banks that created the vehicles, so investors only received general descriptions of the assets  
10 backing their investments. S&P, however, received detailed information about every single asset  
11 backing the securities it rated. It claimed to carefully evaluate each asset before rating the  
12 securities. Lacking the same level of information, investors had little choice but to rely on ratings  
13 from S&P and its competitors.

14 5. Another reason S&P's ratings played a key role was the fact that most purchasers  
15 of structured finance securities had investment rules that sharply limited their ability to buy such  
16 securities if they were not rated AAA by at least two of the three leading agencies: S&P,  
17 Moody's, and Fitch. For example, the California Public Employees Retirement System ("PERS")  
18 and the California State Teachers Retirement System ("STRS") had rules that in many instances  
19 required them to buy only AAA-rated structured finance securities. S&P was aware of this and  
20 knew investors would rely on its ratings.

21 6. Relying on S&P's ratings, PERS and STRS collectively purchased billions of  
22 dollars worth of structured finance securities, including those listed on Appendix A. As set forth  
23 in Appendix A, many of those securities were rated AAA by S&P.

24 **III. THE TRUTH ABOUT S&P'S INTEGRITY AND RATINGS**

25 7. In reality, S&P secretly lowered its rating standards in order to gain market share  
26 and increase profits in its rating business. S&P executives were keenly aware of actual and  
27 potential competition and were determined to defeat it – at any cost. They siphoned resources  
28 away from their analysts and intentionally inflated their ratings in order to attract and keep bank

1 business. They suppressed development of new, more accurate rating models that would have  
2 produced fewer AAA ratings – and therefore lower profits and market share. As one senior  
3 managing director at S&P later confessed, “I knew it was wrong at the time.”

4 8. Between 2004 and 2007 (the “Relevant Time Period”), S&P knew that its rating  
5 process and criteria had become so degraded that many of its ratings were, in the words of one  
6 S&P analyst, little better than a “coin toss.” During those years, its models were “massaged”  
7 using “magic numbers” and “guesses,” in the words of other senior S&P executives.

8 9. By 2004, S&P had compromised its rating process to the point where S&P had no  
9 basis to believe that its ratings met its own announced standards. Quite the contrary, S&P had  
10 ample reason to believe the opposite. And S&P in fact did not hold the ratings “opinions” it  
11 represented to investors such as PERS and STRS.

12 10. For example, in 2004, S&P knew that changes in the residential mortgage market  
13 had rendered obsolete its ratings model for residential mortgage backed securities (“RMBS”), one  
14 of the main types of securities at the heart of this case. As a result, S&P’s RMBS model rated  
15 these securities too highly and understated their risks. S&P analysts developed an updated model  
16 that reflected current housing realities. They then tested their new model by running it on a  
17 sample of several RMBS that had already been rated by S&P using its old model. The test results  
18 showed that all of the sample RMBS had substantial flaws and were significantly riskier than  
19 S&P’s ratings indicated. This created a business and ethical problem for S&P. If it used the new  
20 – and more accurate – model, S&P would lose business to less demanding competitors. So S&P  
21 management refused to implement the new, more accurate model. S&P continued to use the  
22 obsolete, inaccurate model for three more crucial years, thus providing inflated ratings to  
23 thousands of RMBS.

24 11. It was not until mid-2007, when the housing bubble had already begun to burst,  
25 that S&P finally authorized an update to its inaccurate RMBS model. Even then, S&P only used  
26 a watered-down version of the proposed 2004 model – which itself had become obsolete over the  
27 three intervening years. Thus, S&P continued to issue RMBS ratings that it knew were inaccurate  
28 and inflated.

1           12.     S&P similarly corrupted its ratings of other mortgage-related structured finance  
2 securities. For instance, it rated notes issued by structured investment vehicles (“SIVs”) –  
3 another type of security central to this case – without obtaining key data about the assets  
4 underlying the SIVs. A reporter later asked the responsible executive about this failing: “If you  
5 didn’t have the data, and you’re a data-based credit rating agency, why not walk away” from  
6 rating these deals? His response was remarkably candid: “The revenue potential was too large.”

7           13.     S&P employees minced no words when describing S&P’s woefully inadequate  
8 ratings process in the mid-2000s. One called it a “f\*\*king scam.” Another said, “Let’s hope we  
9 are all wealthy and retired by the time this house of cards falters.”

#### 10     **IV. THE HOUSE OF CARDS BURNS DOWN**

11           14.     By early 2007, the risk disparity between S&P’s high ratings on structured finance  
12 securities and the low quality of the mortgages backing them had reached the point where it was a  
13 source of humor inside S&P. On March 19, 2007, some of the S&P analysts involved in rating  
14 these securities recorded a parody of the Talking Heads song “Burning Down the House” with the  
15 following lyrics:

16                 Watch out!  
17                 Housing market went softer  
18                 Cooling down  
19                 Strong market is now much weaker  
20                 Subprime is boi-ling ov-er  
21                 Bringing down the house

22                 ...  
23                 Going all the way down, with  
24                 Subprime mortgages.

25           15.     S&P did not share this cautionary ditty with investors. Rather, it continued to  
26 issue ratings that it knew did not capture the risks of the “strong market” for housing – despite the  
27 fact that its analysts clearly were aware that the housing market was “now much weaker.” S&P  
28 even continued to grant AAA ratings to numerous securities backed by toxic subprime mortgages.  
California’s pension funds bought such securities in reliance on S&P’s ratings. And, as predicted  
by S&P’s lyrical analysts, those securities did indeed “go all the way down,” causing massive  
losses to the pension funds and other investors.

1           16. By the second half of 2007, the problems with RMBS and related securities had  
2 become too public for S&P to ignore. Securities that S&P had claimed were in the least risky  
3 possible category, AAA, were defaulting and suffering losses at rates resembling junk bonds.

4           17. S&P therefore decided to downgrade these securities en masse, beginning with  
5 subprime RMBS in July 2007. In the market collapse that occurred after the risky nature of  
6 RMBS and related securities became known, PERS and STRS lost hundreds of millions of dollars  
7 on RMBS and SIVs that had been rated AAA by S&P.

8           18. PERS's and STRS's losses were not a statistical anomaly; they do not represent a  
9 cluster of investments that all happened to fall within the .16% of S&P AAA rated bonds that are  
10 downgraded to junk. Of the AAA ratings granted to RMBS in 2004, between 3% and 50%  
11 (depending on the type of RMBS) were downgraded to junk status. For securities rated AAA in  
12 2005, the percentage downgraded rose from 39% to 81%. For 2006 vintage RMBS, between 81  
13 and 98% of AAA rated RMBS were downgraded to junk. And for RMBS issued in 2007, over  
14 90% became junk. According to the Senate Permanent Subcommittee on Investigations,  
15 "Perhaps more than any other single event, the sudden mass downgrades of MBS and CDO  
16 ratings were the immediate trigger for the financial crisis."

#### 17   **V. THE CALIFORNIA ATTORNEY GENERAL'S INVESTIGATION**

18           19. As the crisis it helped create unfolded, S&P worked vigorously to conceal its  
19 wrongdoing. It denied that its ratings had become inflated or its business corrupted. Its  
20 executives publicly professed to be shocked that anyone could doubt the integrity of their  
21 company or its ratings.

22           20. However, incriminating documents eventually began to trickle out and  
23 whistleblowers came forward. The California Attorney General began investigating S&P's role  
24 in the massive losses inflicted on Californians who invested in structured finance securities. The  
25 California Attorney General's Office has devoted a team of dozens of attorneys, investigators,  
26 and auditors to uncovering the truth about what happened in the years leading up to the financial  
27 crisis. That team has conducted extensive witness interviews, issued dozens of subpoenas, and  
28 collected millions of pages of records.

1 **VI. EVEN TODAY, S&P CONTINUES TO RESIST REFORM**

2 21. Despite the investigations of the California Attorney General, the Securities  
3 Exchange Commission, the U.S. Senate, and others, S&P refuses to change its ways. For  
4 instance, in 2008, S&P hired two outside experts, Mark Adelson and David Jacob, in a public  
5 show of its commitment to clean up its rating business. To the dismay of top S&P executives,  
6 Adelson and Jacob tried to do just that: Adelson began tightening rating criteria and Jacob tried  
7 to restructure S&P's rating business to make it independent and immune from business pressure.

8 22. S&P's top executives soon tried to rein in Adelson and Jacob. S&P's president,  
9 Deven Sharma, called Jacob onto the carpet and "gave him hell" over lost business. After Jacob  
10 explained that the loss of business was in part due to Adelson's tighter criteria, Sharma pressured  
11 Jacob to do something about it, ordering him to consider "changing direction."

12 23. S&P held a leadership meeting in June 2011 with the theme "Relentlessly Driving  
13 Global Growth." Among the lessons S&P top executives sought to impart was that, "Success in  
14 criteria development depends on ongoing collaboration between the criteria group and the  
15 business." A case study presented at the meeting used the loss of business resulting from  
16 Adelson's criteria tightening as an example of the problems that can arise when the criteria group  
17 does not "collaborate" with business.

18 24. Adelson and Jacob still refused to "collaborate" or "change direction" as requested  
19 by their superiors. In December 2011, they were both replaced.

20 **PARTIES**

21 25. Attorney General Kamala D. Harris is the chief law officer of the State of  
22 California. She brings this action on behalf of the People of the State of California.

23 26. Defendant The McGraw-Hill Companies, Inc. ("McGraw-Hill") is a New York  
24 Corporation. McGraw-Hill is registered with the California Secretary of State to conduct  
25 business in the State of California. Throughout the Relevant Time Period, Standard & Poor's was  
26 a business unit within McGraw-Hill that conducted McGraw-Hill's credit rating business. It was  
27 not a separate corporate entity. McGraw-Hill is therefore directly liable for all of the misconduct  
28 described herein during the Relevant Time Period.

1           27. Defendant Standard & Poor's Financial Services LLC is a Delaware limited  
2 liability company registered with the California Secretary of State to do business in the State of  
3 California. It is a wholly-owned subsidiary of Defendant McGraw-Hill. It was formed on  
4 November 18, 2008 to house McGraw-Hill's credit ratings business as of January 1, 2009.

5           28. Standard & Poor's Rating Services is a business unit within Standard & Poor's  
6 Financial Services LLC. It operates as a credit rating agency that purports to analyze the  
7 creditworthiness of a particular company, security or obligation, including structured finance  
8 securities.

9           29. Plaintiff the People of the State of California are not aware of the true names and  
10 capacities of the defendants sued as Does 1 through 100, inclusive, and therefore sue these  
11 defendants by such fictitious names.

12           30. Each of these fictitiously named defendants is responsible in some manner for the  
13 activities alleged in this Complaint. Plaintiff will amend this Complaint to add the true names of  
14 the fictitiously named defendants once they are discovered.

15           31. The named and unnamed defendants in this action are collectively referred to as  
16 "Defendants."

17           32. Unless otherwise alleged, whenever this Complaint refers to any act of  
18 Defendants, such allegation shall mean that each Defendant acted individually and jointly with  
19 the other Defendants named in this Complaint.

20           33. Unless otherwise alleged, whenever this Complaint refers to any act of any  
21 corporate or other business Defendant, such allegation shall mean that such corporation or other  
22 business did the acts alleged in this Complaint through its officers, directors, employees, agents  
23 and/or representatives while they were acting within the actual or ostensible scope of their  
24 authority.

25           34. At all times relevant to this Complaint, each of the Defendants has acted as an  
26 agent, representative, or employee of each of the other Defendants and has acted within the  
27 course and scope of said agency, representation, or employment.  
28

## OTHER RELEVANT ENTITIES

35. PERS is the largest public pension fund in the United States. It provides retirement and health benefits to more than 1.6 million California public employees, retirees and their families. PERS's members include California firefighters, peace officers and other public employees.

36. STRS provides retirement, disability and survivor benefits for over 850,000 of California's prekindergarten through community college educators and their families. STRS, whose mission is to secure the financial future of California's educators, is the largest teachers' retirement fund in the United States.

37. PERS and STRS are arms of the State of California, operating under the California Constitution and the California Government Code. Pursuant to the California Constitution, the boards of PERS and STRS are bound by a "fiduciary responsibility for investment of moneys and administration of the [public pension] system."

## JURISDICTION

38. This Court has jurisdiction to hear the claims alleged in this Complaint and is a court of competent jurisdiction to grant the relief requested.

## VENUE

39. At all relevant times alleged in this Complaint, Defendants maintained an office and did business in the City and County of San Francisco.

40. Violations of law alleged in this Complaint occurred in the city and county of San Francisco.

## PERS, STRS, AND OTHER INVESTORS PURCHASED STRUCTURED FINANCE SECURITIES IN RELIANCE ON S&P'S INTEGRITY AND RATINGS

41. PERS and STRS were among the largest institutional investors in structured finance securities during the Relevant Time Period. In reliance on S&P's ratings and integrity, PERS and STRS purchased large portfolios of structured finance securities, including but not limited to those listed on Appendix A.

## I. STRUCTURED FINANCE SECURITIES PURCHASED BY PERS AND STRS



1           42.     Structured finance refers to the process of securitizing the cash flow from an asset  
2 or pool of assets, typically loans or other debt instruments. A structured finance security is the  
3 financial product that results from this securitization. The most significant types of structured  
4 finance securities for purposes of this action, RMBS and SIV notes, are described below.

5           **A.     Residential Mortgage Backed Securities**

6           43.     RMBS are securities issued by a trust containing a pool of residential mortgages.  
7 The underlying mortgages serve as collateral for investors who purchase the securities. Payments  
8 by borrowers create the income received by RMBS investors.

9           44.     The process of creating an RMBS begins when a financial institution, most often a  
10 bank, packages mortgage loans into a pool and transfers them to a trust that will issue securities  
11 collateralized by the pool. The trust purchases the loan pool and becomes entitled to the principal  
12 and interest payments made by the borrowers. The trust then uses payments from the borrowers  
13 to make monthly payments to the investors in the RMBS.

14          45.     To appeal to investors with different risk appetites, the trust issues different classes  
15 of securities, known as “tranches,” which offer a sliding scale of return rates based on the  
16 riskiness of the tranche. The tranches are typically arranged in a “waterfall” in which tranches at  
17 the top of the waterfall are paid first, tranches immediately below them are paid once the top  
18 tranches have received all their money, and so on. The bottom tranches only get paid if every  
19 tranche above them has been paid in full. The bottom tranches are the riskiest and receive the  
20 highest return rates in order to compensate their holders for the possibility that they might not be  
21 paid at all. The top tranches are the safest and therefore receive the lowest return rates.

22           **B.     Structured Investment Vehicles**

23          46.     Before they all imploded during the 2007-08 financial crisis, SIVs were special-  
24 purpose companies that held portfolios of long-term asset-backed securities and bonds. They  
25 financed these holdings by issuing short-term debt securities, such as commercial paper and  
26 medium term notes (collectively “Senior Notes”) and mezzanine capital notes (“Capital Notes”).  
27 Because long-term assets typically earn higher returns than short-term securities, a SIV could  
28

1 reap profits on the income spread between its assets and its liabilities, after subtracting  
2 management fees and other costs.

3 47. SIVs had relatively small capital cushions, so most losses on a SIV's assets were  
4 passed on to the SIV's investors. As a result, the SIV's notes were vulnerable to even small  
5 declines in the value of the asset portfolio held by the SIV.

6 48. SIV asset managers, who provided advice and support, actively managed a SIV's  
7 assets, meaning that they had the authority to purchase and sell within the limits outlined in the  
8 SIV formation documents. These asset managers also ran many structural tests, often daily, to  
9 determine whether the SIV possessed adequate capital, collateral, and liquidity. SIVs had a  
10 liability "waterfall" similar to RMBS: SIV equity (effectively the bottom tranche of a SIV) took  
11 the first losses, followed by junior, medium-term debt, and last, commercial paper and medium  
12 term notes.

13 49. RMBS and related securities called collateralized debt obligations ("CDOs") were  
14 among the largest classes of long-term assets held by the SIVs at issue in this case.

15 50. The process for creating a typical CDO was similar to that for an RMBS.  
16 Specifically, a sponsor created a trust or other special purpose entity to hold assets and issue  
17 securities. Instead of the mortgage loans that are held in RMBS pools, a CDO trust typically held  
18 debt securities such as corporate or municipal bonds, junior tranches of RMBS, or credit  
19 derivatives, such as equity tranches of other CDOs. The trust then used the interest and principal  
20 payments from the underlying debt securities to make interest and principal payments to  
21 investors.

## 22 **II. S&P'S RATINGS PLAYED A KEY ROLE IN PERS'S AND STRS'S PURCHASES OF** 23 **BILLIONS OF DOLLARS WORTH OF STRUCTURED FINANCE SECURITIES**

24 51. S&P's ratings were highly material factors in PERS's and STRS's purchases of  
25 structured finance securities. S&P's ratings had a natural tendency to influence, and did  
26 influence, PERS's and STRS's decisions to buy structured finance securities during the Relevant  
27 Time Period, including but not limited to each of the securities listed on Appendix A.  
28

1           52.     PERS's and STRS's investment rules placed strict limits on their investments in  
2 securities that did not receive high ratings, as did the rules of the vast majority of institutional  
3 investors. These rules implicitly or explicitly required institutional investors to buy large  
4 quantities of AAA-rated securities.

5           53.     Even in those portfolios where PERS and STRS could invest in securities that did  
6 not have high ratings, S&P's ratings were nonetheless material to the pension funds' purchase  
7 decisions. For instance, S&P typically received much more information about the securities it  
8 rated than PERS or STRS did. Further, S&P usually had substantially more time to evaluate  
9 these securities than PERS or STRS did. The pension funds often had only a few hours in which  
10 to review offering documents for a security before deciding whether to purchase it. By contrast,  
11 S&P generally had weeks to come up with a rating.

12           54.     S&P's ratings were also highly material to PERS and STRS apart from the pension  
13 funds' reliance on them. A credit rating does more than simply measure the credit risk of a  
14 security; the rating also dictates the market for the security. Because the vast majority of  
15 institutional investors have rules requiring them to buy highly rated – often AAA – securities, the  
16 market for such securities is significantly larger and more liquid than the market for lower-rated  
17 securities. Thus, a security with an AAA from S&P will be worth substantially more than an  
18 identical BBB-rated security.

19           55.     Further, S&P's representations about its integrity were also material to PERS and  
20 STRS. S&P played a central and trusted role in the structured finance market, rating well over  
21 90% of the structured securities issued during the Relevant Time Period. Its ratings were one of  
22 the foundations on which that market was built. If market participants knew that foundation was  
23 flawed – that S&P had intentionally corrupted its rating process in order to win more fees from  
24 issuers and more market share from its competitors – they would have left the market before it  
25 collapsed.

1                   **S&P'S REPRESENTATIONS ABOUT ITS INTEGRITY AND RATINGS**

2   **I.    S&P KNEW AND INTENDED THAT CALIFORNIA'S PENSION FUNDS AND OTHERS**  
3       **WOULD RELY ON ITS REPRESENTATIONS**

4           56.    For years, S&P engaged in a concerted campaign to convince investors such as  
5   PERS and STRS that it was a paragon of integrity and professionalism and that its ratings were  
6   reliable. An S&P executive summarized S&P's public facade while testifying to Congress in  
7   2002: "Standard & Poor's credit ratings have gained respect because they are based on objective  
8   and credible analyses. . . . We are not a company's advocate. We're not their dis-advocate. We  
9   really don't care. We're there just to call it as we see it, as a third-party, objective, credible  
10   opinion. . . ."

11           57.    S&P fully understood – and intended – the weight investors placed on its ratings.  
12   As its President testified in 2002, "the fundamental reason that Standard & Poor's and others'  
13   ratings have grown in importance in our capital markets is our long track record of providing  
14   independent, objective, and reliable opinions on creditworthiness." "We fully recognize the value  
15   that we add to the markets and understand that it rests on a platform of integrity, objectivity, and  
16   independence. . . . [A]ll our processes, our standards, our methodologies are geared to meeting  
17   the objectives of integrity, quality objectivity, credibility and independence."

18           58.    As noted by the Senate Permanent Subcommittee on Investigations, "[b]ecause  
19   structured finance products are so complicated and opaque, investors often place particular  
20   reliance on credit ratings to determine whether they should buy them."

21           59.    S&P not only made such representations publicly, it engaged in concerted private  
22   efforts to encourage large investors to rely on its expertise and ratings. For example, S&P sent  
23   analysts and executives on "road shows" in which they would visit PERS and other large  
24   investors to, among other things, promote S&P's ratings and other products, answer questions  
25   about their methodologies, and build relationships with investors.

26           60.    S&P intended that government investors, including pension funds, would rely on  
27   its ratings of structured finance securities. In a February 16, 2007 publication called "25 Years of  
28   Credit: The Structured Finance Market's Accumulated Wisdom," S&P wrote that its ability to

1 assign ratings to RMBS “enabled conservative investors, such as pension funds and insurance  
2 companies, to gauge the risk of structured finance investments without tying up valuable  
3 resources by having to analyze the underlying assets themselves.”

4 61. S&P knew and intended that issuers of securities would use its ratings to get  
5 PERS, STRS, and other investors to buy the rated securities. Accordingly, S&P repeatedly,  
6 consistently, and publicly proclaimed to investors and other participants in the financial markets  
7 that its credit ratings, including those of structured finance securities, were independent,  
8 objective, and based on a reliable rating process. Examples of those representations are listed  
9 below by subject matter.

## 10 II. S&P’S REPRESENTATIONS ABOUT ITS INTEGRITY AND COMPETENCE

### 11 A. S&P Represented That It Would Not Succumb to the Conflict of Interest 12 Inherent in Its Issuer Pays Business Model and Would Not Act as an Advisor on Securities It Rated

13 62. During the Relevant Time Period, credit rating agencies, including S&P, were paid  
14 billions of dollars by the same entities that issued the structured finance securities that the rating  
15 agencies were rating. Specifically, in exchange for providing credit ratings on structured finance  
16 securities, rating agencies charged the issuer a fee based on the complexity and size of the  
17 structured finance security being rated. This compensation model is commonly referred to as the  
18 “issuer pays” model.

19 63. S&P has conceded that the issuer pays model created a technical conflict of  
20 interest. However, S&P claimed to have internal controls to prevent the issuer pays model from  
21 impacting its ratings. S&P made these representations many times in many settings.

22 64. Section 3.1.5 of S&P’s September 2004 Code of Practices and Procedures (the  
23 “Code” or “S&P Code”) states: “Ratings assigned by [S&P] shall not be affected by an existing  
24 or a potential business relationship between [S&P] (or any Non-Ratings Business) and the issuer  
25 or any other party, or the non-existence of such a relationship.” According to S&P, “the fact that  
26 [S&P] receives a fee from the issuer must not be a factor in the decision to rate an issuer or in the  
27 analysis and the rating opinion.” (S&P Code § 3.1:2.)  
28

1           65.     S&P also assured the public that the role of issuers in the rating process would be  
2 limited, representing that S&P “shall not accept any qualitative or editorial revisions from issuers  
3 that affect the presentation of the rating.” (S&P Code § 1.3.8.)

4           66.     In a document formerly available on its website, “The Fundamentals of Structured  
5 Finance Ratings,” S&P acknowledged that the “issuer pays” model could compromise its analysis  
6 but reassured investors by stating, “[w]e are intensely aware that our entire franchise rests on our  
7 reputation for independence and integrity. Therefore, giving in to ‘market capture’ would reduce  
8 the very value of the rating, and is not in the interest of the rating agency.”

9           67.     S&P’s President, Leo C. O’Neill, represented to the SEC in 2003 that S&P was  
10 committed to protecting the ongoing value of its reputation and future as a credit rating business  
11 by ensuring the integrity, independence, objectivity, transparency, and credibility of its ratings.  
12 According to O’Neill, no single issuer fee or group of fees would be important enough to risk  
13 jeopardizing S&P’s reputation and future.

14           68.     In its public statements, S&P also assured investors that its role in the capital  
15 markets was limited to *rating* securities, not structuring them. For example, in section 1.1.5 of its  
16 Code, S&P stated that it “does not act as an investment, financial, or other advisor to, and does  
17 not have a fiduciary relationship with, an issuer or any other person. [S&P] does not become  
18 involved with the actual structuring of any security it rates, and limits its comments to the  
19 potential impact that any structuring proposed by the issuer may have on the rating.”

20           **B.     S&P Represented That It Had Adequate Staffing and Resources to Provide**  
21           **Credible Ratings**

22           69.     S&P also continuously represented that it had the expertise and resources to  
23 evaluate complex securities and assign accurate ratings to them.

24           70.     For example, in its 2004 annual report, McGraw-Hill touted S&P’s purported  
25 ability to provide “investors with the independent benchmarks they need to feel more confident  
26 about their investment and financial decisions.” McGraw-Hill’s 2006 annual report stated, “[a]s  
27 financial markets grow more complex, the independent analysis . . . offered by [S&P is] an  
28 integral part of the global financial infrastructure.” In its 2007 annual report, McGraw-Hill

1 claimed that S&P's "capabilities and expertise continue to expand to meet the complex demands  
2 of the global financial markets." McGraw-Hill also made similar representations in its 2006 and  
3 2008 reports.

4 71. In its Code, S&P claimed that it would not issue a rating until all "appropriate  
5 analyses have been performed." (S&P Code § 1.2.1.) According to S&P, any rating conclusion  
6 had to be approved by a rating committee "utilizing [S&P]'s established criteria and  
7 methodologies." (S&P Code § 1.3.3.)

8 72. S&P publicly detailed its processes and procedures for arriving at reliable and  
9 consistent ratings. S&P claimed that it employed "specific credit analysis factors to ensure that  
10 all relevant issues are considered during the credit rating and surveillance processes." (S&P Code  
11 § 1.7.1.) S&P represented that "[i]n order to maintain consistency of ratings," S&P's Analytics  
12 Policy Board would be responsible for "monitoring the quality of, and adherence to, the rating  
13 definitions, criteria, methodologies, and procedures and for approving any significant changes to  
14 the rating definitions, criteria, methodologies and procedures." (S&P Code § 1.7.3.)

15 **C. S&P Represented That It Monitored Securities After Rating Them to**  
16 **Ensure That They Continued to Deserve Their Ratings**

17 73. S&P also publicly promoted the robust and reliable nature of its rating surveillance  
18 processes.

19 74. S&P promised that it would "monitor the rating on an ongoing basis . . . in  
20 accordance with a surveillance policy established by [S&P]. The Chief Credit Officer and the  
21 Analytics Policy Board shall be responsible for overseeing and reviewing [S&P]'s surveillance  
22 policy and for ensuring that the surveillance policy results in credible credit ratings." (S&P Code  
23 § 1.4.1.)

24 75. Section 1.9 of S&P's 2005 Code of Conduct states: "[O]nce a rating is assigned  
25 [S&P] shall monitor on an ongoing basis and update the rating by: (a) regularly reviewing the  
26 issuer's creditworthiness; (b) initiating a review of the status of the rating upon becoming aware  
27 of any information that might reasonably be expected to result in a Rating Action (including  
28

1 withdrawal of a rating), consistent with the applicable rating criteria and methodology; and, (c)  
2 updating on a timely basis the rating, as appropriate, based on the results of such review.”

### 3 **III. S&P’S REPRESENTATIONS REGARDING ITS RATINGS**

#### 4 **A. S&P’s Ratings Scale**

5 76. Throughout the Relevant Time Period, S&P’s ratings of structured finance  
6 securities took the form of a letter grade rating. Ratings AAA, AA, A, BBB, BB, B, CCC, CC, C,  
7 and D had less creditworthiness with each succeeding reduction in grade level.

8 77. According to S&P, AAA-rated securities should, on average, be able to withstand  
9 the economic conditions of the Great Depression.

10 78. S&P could also modify its ratings between AA and CCC by attaching a plus (+) or  
11 minus (-) sign to show the relative standing within the major rating categories.

12 79. S&P described its ratings in the following way:

13 AAA: Extremely strong capacity to meet financial commitments.  
Highest rating.

14 AA: Very strong capacity to meet financial commitments.

15 A: Strong capacity to meet financial commitments, but somewhat  
16 susceptible to adverse economic conditions and changes in  
circumstances.

17 BBB: Adequate capacity to meet financial commitments, but more subject  
to adverse economic conditions.

18 BBB-: Considered lowest investment grade by market participants.

19 80. S&P also provided credit ratings on short-term issues (generally, issues with  
20 maturities of one year or less, such as commercial paper) on a scale from A-1+ to D. An A-1+  
21 rating indicated that the issue’s capacity to meet its financial commitments was extremely strong.

#### 22 **B. General Overview of S&P’s Rating Process**

23 81. Within S&P’s Structured Finance division, ratings analysts were assigned to rate a  
24 proposed deal based on their specialization in that type of deal.

25 82. Based on their analyses, S&P’s ratings analysts developed a recommendation for a  
26 final credit rating for each class of securities issued as part of the deal. The recommendation was  
27 presented to an internal S&P ratings committee made up of senior analysts and/or ratings  
28 analytical managers, for final approval. The committee was charged with considering relevant



1 information and applying appropriate criteria and methodologies. At the rating committee  
2 meeting, pertinent information and a rating recommendation were presented and discussed. Then  
3 the committee voted on the recommendation.

4 83. After S&P issued a rating on a security, the rating was transferred to the S&P  
5 Surveillance Group within Structured Finance for monitoring. The Surveillance Group and  
6 S&P's internal rating committee for each structured finance category were responsible for  
7 monitoring the rated security.

#### 8 1. Overview of S&P's RMBS rating process

9 84. In addition to the process and criteria applied in rating all structured finance deals,  
10 S&P used a model called Loan Evaluation and Estimate of Loss System ("LEVELS") to rate  
11 RMBS offerings. LEVELS was a statistical computer model that evaluated the overall  
12 creditworthiness of a pool of mortgage loans underlying an RMBS transaction. Using LEVELS,  
13 S&P analyzed each mortgage loan's characteristics, such as equity, loan type, income  
14 verification, whether the borrower occupies the home, and the purpose of the loan.

15 85. According to Frank Raiter, the Managing Director of S&P's Residential Mortgage  
16 Rating Group from 1995 until 2005, the accuracy of the LEVELS model was critical to the  
17 quality of ratings. The accuracy of LEVELS depended on the quality and quantity of loan data  
18 collected and analyzed by S&P. Each new version of LEVELS was built with growing data on  
19 traditional as well as new mortgage products. That is why, until the early 2000's, each version of  
20 the model was better than its predecessor in determining default probabilities.

#### 21 2. S&P's SIV rating process

22 86. During the Relevant Time Period, S&P represented to investors that the touchstone  
23 of its SIV ratings was a defeasance analysis: S&P would determine whether the senior debt of the  
24 SIV would remain AAA/A-1+ rated until the last senior obligation had been honored in case the  
25 SIV needed to be wound down. In other words, to be confident that a SIV's senior liabilities  
26 were able to maintain the highest possible ratings until maturity, S&P said that it measured the  
27 SIV's capital adequacy by assuming that the SIV entered into immediate wind-down, sometimes  
28 referred to as "defeasance" or "enforcement." Thus, according to S&P, it based its analysis on

1 the following question: If the SIV enters into defeasance or enforcement today, can it repay all its  
2 senior liabilities as they come due by selling its assets? If – and only if – the answer to that  
3 question was ‘yes’ in virtually any conceivable circumstance, the SIV could receive an AAA/A-  
4 1+ rating.

5 87. S&P represented that it analyzed whether, in all of the SIV’s operating states, the  
6 credit, market, liquidity, hedging, and operational risks were covered to an AAA level – meaning  
7 that the SIV would be able to pay all of its senior liabilities in any foreseeable situation.

8 88. S&P also provided “capital matrices” to determine the base minimum amount of  
9 capital allowed before a SIV would be required to operate in a more conservative way. These  
10 operating instructions were themselves based on the ratings of the assets that the SIV would  
11 acquire. Each time the SIV selected a potential investment to be acquired, it would determine the  
12 weighted average life of the asset, its credit rating, and the asset class – such as non-prime  
13 mortgage-backed securities – from which the investment is drawn.

14 89. Based on these parameters, on an asset-by-asset basis, a SIV would set aside a  
15 predetermined amount of capital for the protection of the Senior Notes and Capital Notes and the  
16 preservation of their respective ratings. The percentage of capital required was negotiated in  
17 advance with S&P.

18 90. S&P also represented that it stress tested CDOs, a major component of the  
19 portfolios held by many SIVs – including those at issue in this case. S&P used a model called  
20 CDO Evaluator to rate CDOs. The heart of the Evaluator model was a “Monte Carlo” simulation  
21 of defaults with correlations, to estimate default rates for different asset pools in CDO deals.  
22 S&P claimed that the simulation tested CDOs against every conceivable economic scenario.

23 91. During the Relevant Time Period, documents describing the SIVs and S&P’s  
24 criteria for rating them were distributed or made available to investors, including PERS’s  
25 investment managers. These documents included the key terms of each SIV’s rated Senior Notes  
26 and Capital Notes as well as representations that the Senior Notes would be rated AAA/A-1+ by  
27 S&P, and that the SIV itself was AAA.

1           92.     The AAA/A-1+ ratings assigned to the senior liabilities of all of the SIVs were  
2 S&P's highest long- and short-term rating categories. S&P also provided counterparty credit  
3 ratings of AAA/A-1+ for all the SIVs it rated.

4           93.     S&P also represented to investors that it regularly and systematically monitored  
5 and cross-checked the performance of each SIV's asset portfolio. To check that a SIV had  
6 sufficient capital, its portfolio was to be monitored on a daily basis by marking to market each  
7 asset in the portfolio. Thus, any asset trading below par would have an impact on the net asset  
8 value of the SIV and the level of capital that it might require to maintain an AAA rating. Market  
9 prices had to be provided by pricing sources approved by S&P. In addition to monitoring the  
10 SIVs' asset prices and performance, on an ongoing basis, S&P received extensive weekly reports  
11 from the SIVs to fully survey all operating guidelines, liquidity levels, and other aspects of the  
12 SIVs.

13           94.     Unlike the investors in the SIVs, S&P had an ongoing involvement in the SIV  
14 transactions and played an integral role in monitoring each SIV's covenants and covenant  
15 breaches. S&P was also involved in approving substitutions and changes to the SIVs' asset  
16 portfolios.

17                   **ALL OF S&P'S REPRESENTATIONS WERE KNOWINGLY FALSE**

18           95.     S&P's representations about its integrity, competence, and the quality of its ratings  
19 were knowingly false. Specifically, S&P made each of the above representations with actual  
20 knowledge that it was false, in reckless disregard of its truth or falsity, or in deliberate ignorance  
21 of its truth or falsity. Further, each individual speaker was authorized to speak on behalf of S&P  
22 when he or she made the misrepresentations at issue.

23           96.     In reality, S&P intentionally corrupted both its ratings and its later surveillance of  
24 those ratings. That corruption took many and complex forms, some of which affected only one  
25 class of securities and some of which affected all classes. But a consistent theme ran through all  
26 of S&P's misdeeds: S&P would do anything to maximize its market share and profits. As one  
27 S&P senior executive later put it, S&P "felt more like the Wild West," and tightening rating  
28 criteria "puts a crimp on the business."

1           97.     The Senate Permanent Subcommittee on Investigations concluded that S&P  
2 corrupted its ratings a number of ways:

3           The ratings agencies weakened their standards as each competed to provide the most  
4 favorable rating to win business and greater market share. The result was a race to  
5 the bottom. Additional factors responsible for the inaccurate ratings include rating  
6 models that failed to include relevant mortgage performance data, unclear and  
7 subjective criteria used to produce ratings, a failure to apply updated rating models to  
8 existing rated transactions, and a failure to provide adequate staffing to perform rating  
9 and surveillance services, despite record revenues.

10           98.     S&P's top managers knew it was wrong to do these things. In the words of one  
11 senior managing director at S&P, "I knew it was wrong at the time. It was either [weaken our  
12 criteria] or skip the business."

13           99.     A July 2004 Criteria Memo updated S&P's email policy purportedly to promote  
14 the "robust exchange of ideas and opinions among committee members." The policy discouraged  
15 email communications among those involved in the rating committee process and required that all  
16 ratings committee work be done in person or by phone. The email policy further stated:

17           Second-guessing or revisionist history concerning a particular rating decision that  
18 was reached in accordance with Standard & Poor's policies and procedures is  
19 inappropriate behavior irrespective of the method of communication chosen.  
20 Similarly, commenting on rating decisions in which you were not directly involved  
21 or have sufficient knowledge of is inappropriate.

22           Despite this policy, many emails, including those discussed below, confirm S&P's wrongdoing as  
23 well as the conclusions reached by the Senate and the allegations in this Complaint.

24           100.     S&P's representations at issue in this action connoted actual, objectively verifiable  
25 facts. S&P neither genuinely nor reasonably believed these representations, and the  
26 representations were without basis in fact. S&P had knowledge of facts that contradicted its  
27 representations and lacked knowledge of facts to support them. S&P did not genuinely, honestly,  
28 or reasonably entertain beliefs or "opinions" included in or implied by their representations.  
Further, S&P had knowledge and information superior to that of investors, including PERS and  
STRS, regarding the subjects of those representations. S&P's representations, including matters  
they implied, did not reflect its actual beliefs. Further, S&P's statements knowingly omitted facts  
tending to seriously undermine the accuracy of the statements.

1           101. S&P's representations were deliberate affirmations of the matters stated, rather  
2 than just causal expressions of belief. S&P's representations implied certainty as to matters stated  
3 or implied. S&P possessed or held itself out as possessing superior knowledge or special  
4 information or expertise regarding the subject matters of its representations. Investors, including  
5 PERS and STRS, were situated so that they could and would reasonably rely on S&P's supposed  
6 knowledge, information, and expertise.

7 **I. REASONS FALSE AS TO ALL SECURITIES**

8 **A. S&P Weakened Its Rating Criteria in a Race to the Bottom with Moody's**

9           102. Deviating from its public promises, S&P inflated its ratings in a race to the bottom  
10 with Moody's. This contradicted the claim in S&P's 2005 Code of Conduct that it "ensures that  
11 the integrity and independence of [its rating] processes are not compromised by conflicts of  
12 interest, abuse of confidential information or other undue influences."

13           103. S&P's global marketing strategy, circulated to top S&P executives, left no doubt  
14 that "[p]rotecting our turf means everything to us in 2006."

15           104. S&P was explicitly concerned about matching Moody's rating methods, regardless  
16 of rating quality. As explained by Kai Gilkes, an S&P managing director of quantitative analysis  
17 at the time, analysts were encouraged to loosen criteria:

18           The discussion tends to proceed in this sort of way. "Look, I know you're not  
19 comfortable with such and such assumption, but apparently Moody's are even  
20 lower, and if that's the only thing that is standing between rating this deal and not  
rating this deal, are we really hung up on that assumption?"

21           105. Illustrating Gilkes' point, a May 2004 internal S&P email addressed to Joanne  
22 Rose, the former head of Global Structured Finance, stated that "[w]e just lost a huge . . . RMBS  
23 deal to Moody's due to a huge difference in the required credit support level . . . [which] was at  
24 least 10% higher than Moody's. . . . I had a discussion with the team leads here and we think that  
25 the only way to compete is to have a paradigm shift in thinking."

**B. S&P Loosened Its Rating Criteria Process for All Asset Classes to Serve Its Market Share Goals**

106. The spreading corruption of S&P's rating process was not confined to any particular type of structured finance asset class. Instead, the desire to please issuers tainted the development of rating criteria and proposed changes to rating criteria in each of the practice groups within Structured Finance, including RMBS, CDOs, CMBS, and asset-backed securities ("ABS"). PERS and STRS invested in these types of assets, including those comprising the SIVs.

107. Under the "issuer pays" model, S&P depended upon Wall Street firms to bring it business, and catered to threats that the firms would take their business elsewhere if they did not get the ratings they wanted.

108. Thus, S&P placed a "For Sale" sign on its reputation by March 20, 2001, according to former S&P executive Frank Raiter. On that date, in a harbinger of the collapse of S&P's RMBS rating standards, S&P's highest management ordered a credit rating estimate even though S&P lacked vital loan data to perform the necessary analysis. This resulted in the "most amazing memo" Mr. Raiter had "ever received in [his] business career." When Mr. Raiter requested the necessary loan level data, Richard Gugliada, the head of S&P's CDO group at the time, rejected the request, stating:

Any request for loan level tapes is TOTALLY UNREASONABLE!!! ... Furthermore, by executive committee mandate, fees are not to get in the way of providing credit estimates.... It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.

109. Both Mr. Gugliada and Mr. Raiter later confirmed that providing a credit rating estimate without the necessary data was tantamount to a "guess" which was "by S&P's management policy, approved by the structured finance leadership team."

110. S&P's choice to mirror Moody's rating results made it vulnerable to "rating shopping." For example, in May 2006, an S&P Client Value Manager received an email from an investment banker questioning moderate criteria changes in S&P's RMBS ratings model:

heard you guys are revising your residential mbs rating methodology – getting very punitive on silent seconds. heard your ratings could be 5 notches back of mo[o]dys [sic] equivalent. gonna kill your resi biz. may force us to do moodyfitch only cdos!

1 111. In response, the managing director for RMBS Client Value Managers confirmed to  
2 S&P's senior executives, that S&P would rate deals based on how Moody's rated deals:

3 [T]o say that these changes will leave us 5 notches back of Moody's sounds like a  
4 gross over statement, especially since we have been a notch or two more liberal  
5 then [sic] they have been (causing the split rating issues) for over the last year or  
6 two. The simulations that we did on the impact of our changes, more often then  
[sic] not we believe will bring our requirements close to theirs or in certain  
situations slightly higher. We certainly did [not] intend to do anything to bump us  
off a significant amount of deals.

7 112. In another early example of S&P's race to the bottom, by 2003, S&P already knew  
8 that its rating criteria for CDOs were "random." Thus, in response to an email discussing S&P's  
9 assignment of analysts to work on CDO deals, Dr. Frank Parisi, an S&P Director heavily  
10 involved in the modeling efforts, emailed the head of S&P's Criteria group, and other S&P  
11 managers, describing how S&P relies on "the 'Random Criteria Generator' they use to rate deals  
12 which allows them to rate anything that walks through the door and have surveillance clean it up  
13 later." (Original emphasis.) By using "random criteria" to help issuers, S&P harmed investors  
14 who relied on ratings not knowing that they were based on "random" criteria.

15 113. By July 12, 2004, S&P had decided to ignore its public claim that "[r]atings  
16 assigned by [S&P] shall not be affected by an existing or potential business relationship between  
17 [S&P] (or any Non-Ratings Business) and the issuer or any other party, or the non-existence of  
18 such a relationship."

19 114. Rather, S&P's new Global Structured Finance Criteria Process, circulated to  
20 S&P's top managers in July 2004, and authored by senior executives Joanne Rose and Tom  
21 Gillis, explicitly tied rating criteria to business relationships. It did so under the euphemism  
22 "market appropriateness." The process of changing or adopting new criteria also required a new  
23 explanation of "[d]esired [o]utcome," where the "proposal should indicate what influence the  
24 adoption of the criteria will have on default rates, rating volatility, and market perception and  
25 reaction."

26 115. This new market-focused process was challenged in 2004 – to no avail. For  
27 example, Mr. Raiter – outraged at this new practice – emailed senior executives that "we NEVER  
28

1 poll [investors, issuers, and investment bankers] as to content or acceptability!" (Original  
2 emphasis.) Mr. Raiter added:

3       What do you mean by "market insight" with regard to a proposed criteria change?  
4       What does "rating implication" have to do with the search for truth? Are you  
5       implying that we might actually rate or stifle "superior analytics" for market  
6       considerations?

6       116. Mr. Raiter also testified that until the Criteria Process proposal in July 2004, his  
7       group had never incorporated concepts of "market insight" into development of criteria. He  
8       explained that such considerations impinged on S&P's independence and "didn't have any  
9       relevance" to S&P decisions about developing or implementing new criteria. He also testified  
10      that seeking market perspective for criteria development was "absolutely not the right thing to  
11      do" because it interfered with S&P's independence. In addition, Mr. Raiter could not see why  
12      Client Value Managers (essentially salespeople) should be consulted when developing new  
13      criteria. S&P rejected Mr. Raiter's concerns.

14      117. In this "Wild West" atmosphere, rating criteria were routinely loosened for  
15      business reasons. In August 2004, for example, Ms. Scott, the S&P executive in charge of  
16      CMBS, emailed the head of Structured Finance and other high level managers, saying that "[w]e  
17      are meeting with your group this week **to discuss adjusting criteria for rating CDOs of real**  
18      **estate assets this week because of the ongoing threat of losing deals.**" (Original emphasis.)  
19      This, according to Richard Gugliada, the former managing director of the CDO group, led to S&P  
20      lowering its criteria to accommodate clients. According to Mr. Gugliada, by 2006 S&P had  
21      repeatedly eased its rating standards in "a market-share war where criteria were relaxed." Mr.  
22      Gugliada also admitted that: "I knew it was wrong at the time. It was either that or skip the  
23      business."

24      118. Further, Mr. Gugliada explained that when the subject of tightening S&P criteria  
25      did come up, the co-director of CDO ratings, Dave Tesher, said: "don't kill the golden goose."

26      119. Members of the Structured Finance Leadership Team ("SFLT") also knew of the  
27      corruption of S&P's criteria process. Minutes of an off-site SFLT meeting in London in July  
28



1 2006 noted that analysts were afraid of losing business if criteria changed and that different  
2 offices within S&P applied S&P's July 2004 Criteria Process differently, causing more confusion.

3 120. In another example of S&P's willingness to bend criteria as needed to win deals,  
4 the head of S&P's Global ABS and RMBS Groups in 2004 acknowledged that "flexible criteria"  
5 were a tool to help raise ratings to gain market share. In a June 2004 Activity Report to the head  
6 of the SFLT, Pat Jordan explained how S&P lost two large Japanese RMBS deals because  
7 Moody's heavily undercut its required credit support (a key rating criterion) levels. So, S&P  
8 lowered its own rating criteria to compete with Moody.

9 121. In other words, as another S&P analyst had warned in a June 2005 email to senior  
10 managers, "[s]crewing with criteria to 'get the deal' is putting the entire S&P franchise at risk --  
11 it's a bad idea." Yet, S&P did so repeatedly.

## 12 **II. S&P SUPPRESSED NECESSARY UPDATES TO ITS RMBS LEVELS MODEL TO** 13 **PRESERVE MARKET SHARE**

14 122. S&P represented to the public that its "capabilities and expertise continue to  
15 expand to meet the complex demands of the global financial markets." This was false. The truth  
16 was that S&P deliberately allowed its RMBS rating model, known as LEVELS, to become  
17 obsolete because updating the model would have cost money and market share. S&P's  
18 suppression of updates to its RMBS rating model was an important factor responsible for its  
19 inaccurate ratings of RMBS.

20 123. According to Mr. Raiter, until 2001 S&P's top management had approved and  
21 funded updates and improvements to the LEVELS model, as well as loan data collection and  
22 analysis. However, after 2001 S&P's top management refused to provide the funding and staff  
23 needed to continue developing LEVELS to keep up with rapid growth and changes in the RMBS  
24 market.

25 124. As early as 2004, S&P's own internal analysis of its LEVELS model revealed that  
26 it needed updating because it failed to account for the explosive growth of RMBS. It was also  
27 underestimating the risk of some ALT-A and subprime mortgages, which are loans made to less  
28 credit-worthy borrowers. However, S&P management denied staff budget requests for funding to

1 update the LEVELS model. When pressed, S&P management claimed, in part, that it lacked the  
2 resources for these updates – even though S&P was earning record profits. S&P senior managers  
3 also refused to allocate more resources if doing so would not increase S&P’s already high market  
4 share.

5 125. Even though S&P refused to adequately fund the updating of LEVELS, by 2004  
6 S&P’s RMBS rating group had developed, tested and recommended using an updated “complete”  
7 version of its LEVELS model called LEVELS 6.0. One component of the updated version  
8 allowed for more accurate estimates of the amount of loss if mortgage loans were to default. The  
9 “complete” version of LEVELS 6.0 included a new equation called the “MTI equation” to better  
10 estimate the probability of default of mortgage loans. The MTI equation was derived from an  
11 additional data set of 640,000 mortgage loans.

12 126. In July 2004, S&P testing of the complete version of LEVELS 6.0 showed that the  
13 fully updated model would substantially lower ratings on many types of RMBS, including Prime,  
14 nonprime (including subprime), Alt-A, and with some changes, would also lower Adjustable Rate  
15 Mortgage (“ARM”) and balloon loan ratings. The RMBS rating group recommended releasing  
16 the complete version of LEVELS 6.0 by August of 2004 – but S&P management refused to  
17 authorize the use of LEVELS 6.0 for nearly three more years.

18 127. Dr. Parisi, a Director in S&P’s RMBS rating group deeply involved in developing  
19 the RMBS rating models, explained in a March 23, 2005 email to several senior and managing  
20 directors: “When we first reviewed [LEVELS] 6.0 results \*\*a year ago\*\* we saw the sub-prime  
21 and Alt-A numbers going up and that was a major point of contention which led to all the model  
22 tweaking we’ve done since. Version 6.0 could’ve been released months ago and resources  
23 assigned elsewhere if we didn’t have to massage the sub-prime and Alt-A numbers to preserve  
24 market share.” (Original emphasis.) In response, an RMBS Client Value Manager acknowledged  
25 that he had influenced S&P’s decision to delay releasing LEVELS 6.0, directly contravening  
26 S&P’s representations about its rating process.

27 128. S&P not only failed to implement LEVELS 6.0 in 2004, it also ignored another  
28 proposed improved model, LEVELS 7.0, first proposed the same year. Although LEVELS 6.0

1 would have been an improvement over the version of LEVELS in effect in 2004, it would not  
2 have fully captured the risk of all non-conforming loans. As a result, S&P's RMBS rating group  
3 had also taken significant steps towards developing LEVELS 7.0, which would have been based  
4 on new variables. LEVELS 7.0 would also have incorporated an updated MTI equation based on  
5 2.8 million loans.

6 129. S&P's Executive Committee and senior management were told in late 2004 that  
7 LEVELS 7.0 would have been "by far the most robust model." Among other upgrades, it would  
8 have improved upon LEVELS 6.0 by adding High LTV and second mortgages including, home  
9 equity loans ("HEL"), Home Equity Line of Credit ("HELOC") and closed end seconds – all  
10 assets contained in RMBS that PERS or STRS invested in. However, S&P management refused  
11 to implement LEVELS 7.0.

12 130. S&P also failed to use loan data it already had, or to acquire more loan data that  
13 was readily available, to ensure accurate ratings. Mr. Raiter testified that when he retired from  
14 S&P in early 2005, S&P had a hard drive with almost 10 million more loans that could have been  
15 used to improve S&P's loan ratings, but were not.

16 131. It was not until March 2007 that S&P management finally allowed a watered-  
17 down LEVELS 6.0. Even then, it was only effective starting with deals rated in May 2007.  
18 Compounding the harm from the delay, S&P management only permitted the use of the  
19 incomplete version of LEVELS 6.0 - without the MTI equation – not the more robust "complete"  
20 version of LEVELS 6.0.

21 132. Even further compounding the harm, data that was valid for the rising housing  
22 market of 2004 was obsolete by 2007, when the housing market had peaked. Thus, the  
23 incomplete version of LEVELS 6.0 released in 2007 was already obsolete and inadequate.

24 133. Due to these flaws, the released version of LEVELS 6.0 was little better than "a  
25 coin toss" for rating Prime, Alt-A and subprime RMBS, as shown in an April 2007 study by an  
26 S&P Director who helped develop LEVELS versions 6.0 and its predecessors. That was not an  
27 off-the-cuff opinion, but one reached after studying the predictive power of the released version  
28 of LEVELS 6.0.

134. Former S&P Managing Director Frank Raiter further testified that "... if S&P had vigorously pushed to implement [the LEVELS model] based on the 2.8 million loan data set in later 2004 or early 2005, the economics of deals incorporating the lowest quality subprime and Alt-A loans would have disappeared."

135. S&P's concerns about keeping and growing its market share trumped implementing updated LEVELS models recommended by its ratings group. Those models would have accounted for the higher risks associated with the increase in subprime and Alt-A loans of RMBS transactions – but that was not S&P's goal. S&P did not want to increase the accuracy of its models if doing so would decrease its profits or market share. As a result, rather than spend the necessary funds to implement LEVELS 6.0 in 2004, S&P's management sought to "massage" the subprime and Alt-A numbers to continue to rate offerings and not lose market share.

**A. S&P Used "Magic Numbers" and Guesses to Rate Deals for the Sake of Maintaining RMBS Market Share**

136. As discussed above, following 2001, S&P's RMBS group knew that LEVELS was inaccurate, but S&P refused to make it accurate because accurate ratings would hurt business. Its solution to this dilemma was again to use guesswork: making up key numbers as part of LEVELS to further justify inflated RMBS ratings.

137. In early 2005, rather than implement LEVELS 6.0, S&P applied "magic numbers" to its outdated version of LEVELS. As Mr. Raiter later testified:

A lot of the adjustments that were made to the -- to the [LEVELS] model, in 2005 and '6, as it was pointed out in some of your exhibits, were, in fact, variables or multiples applied to existing output to change those numbers. And when they referred, in Frank Parisi's e-mail, to massaging the data so that you got answers that weren't as extreme as the modeling analysis suggested, that was accomplished with magic numbers.

138. In another example of arbitrary numbers, in an internal February 8, 2006 email, an S&P employee described to senior RMBS managers how he manipulated payment dates in LEVELS to try to improve the rating of an RMBS to satisfy the issuer: "I changed the first payment date for all loans that were seasoned 5 years or greater back to their original date so they would receive credit in LEVELS (approx 17.4% of total pool balance). The net effect was not as

1 great as expected.” In response, an S&P senior director condoned the method and wrote: “I don’t  
2 think this is enough to satisfy them. What’s the next step?”

3 139. S&P also “tweak[ed]” its LEVELS model to maintain “minimal business  
4 disruption” which was a euphemism for preserving its market share. The focus was on business,  
5 not the model’s accuracy. For example, in April 2006, an S&P analytical manager in the US  
6 RMBS sector admitted that, “. . . for LEVELS the ‘better’ model choice will be driven more by  
7 consistency and minimal business disruption than by model performance measures. From past  
8 experience this is a give and take -- so we may find the model ‘makes sense’ for some asset  
9 classes but not others, and we can tweak those cases where we need it to satisfy the business  
10 concern.”

11 140. Thus, not only did S&P use outdated models, but it also improperly modified the  
12 actual economics of the underlying assets to accommodate issuers.

13 **B. S&P Further Corrupted Its Ratings Process for RMBS Comprised of**  
14 **HELOC and ARM Securities**

15 141. Besides knowingly relying on the obsolete LEVELS model riddled with “magic  
16 numbers,” S&P also compromised its ratings of HELOC and ARM securities by using unsound  
17 Constant Prepayment Rates and loss calculation methods. PERS and STRS invested in these  
18 securities as well.

19 142. Constant Prepayment Rate (“CPR”) was another critical component of rating  
20 RMBS, including RMBS made of HELOC and ARM loans. CPR measured the rate (or speed) at  
21 which borrowers prepaid loans ahead of schedule. Accurate cash flow calculations to support  
22 accurate ratings for HELOC and ARM securities required accurate estimates of the CPRs for the  
23 underlying mortgage loans. However, the credit performance of a loan pool depended on the *type*  
24 of loans each pool contained (e.g., prime, Alt-A, and subprime). Each loan type had its own  
25 characteristics and risks concerning expected losses and loan prepayment behavior. Lower risk  
26 prime borrowers might have higher prepayment rates than riskier subprime borrowers. Yet  
27 S&P’s rating methods failed to capture the differences in CPRs arising from the different  
28 prepayment ability of such borrowers. S&P was aware of the need to have accurate CPR criteria

1 for accurate RMBS ratings as early as 2001, yet – as with other criteria – chose **not** to update its  
2 RMBS rating methods.

3 143. By October 2003, S&P's Criteria Committee was informed that S&P calculated  
4 HELOC CPR using an approach that was "not analytically sound." S&P's practice was to  
5 erroneously assume that HELOCs simply paid at the same rate as subprime mortgages. S&P also  
6 knew that it did not yet model HELOCs and would need to either include HELOCs in LEVELS  
7 or create a new model. No action was taken during this time, or even by July 2004, when a key  
8 S&P rating model analyst warned RMBS managers of her belief that CPR speeds were "going to  
9 dramatically rise" on HELOCs. In August 2004, another rating RMBS rating analyst again  
10 warned senior RMBS management of the need to "develop sensible CPR curves."

11 144. As early as January 2002, directors in the RMBS group responsible for LEVELS  
12 were also provided an equation to better model HELOC losses under stressful scenarios as part of  
13 LEVELS. Yet as of April 2005, S&P still had not included the HELOC equation – even though  
14 the head of RMBS and others were informed that S&P's failure to implement the HELOC  
15 equation of January 2002 "[did] NOT bode well." (Original emphasis.) Despite knowledge of the  
16 modeling problems for HELOCs, S&P did not act until 2008, when it finally included a HELOC  
17 component with the release of LEVELS 6.3.

18 145. Further, high-level S&P managers were aware in June 2006 that CPRs also posed  
19 a problem for rating securities based on ARMs. Internally, S&P had serious concerns about  
20 CPRs and was "worried that this is going to blow up in our faces." Specifically, S&P analysts  
21 writing an article on CPRs were instructed by Tom Warrack, Managing Director of Client Value  
22 Managers, to "[c]hange the introduction of the article from saying that S&P expects slower CPRs  
23 in the future, to explaining why prepayments haven't slowed and mention what economic events  
24 would need to transpire in order to slow down prepayments." This caused the analyst to email  
25 that "Tom is being very reckless and I'm worried that this is going to blow up in our faces."  
26  
27  
28

1           **C.   S&P Also Suppressed and Stalled Updates to Its CDO Rating Model and**  
2           **Related Criteria**

3           146.   No later than 2005, S&P management knew that its CDO Rating Model, CDO  
4   Evaluator, needed updating, and that the version in effect in December 2005 included “outdated  
5   assumptions.”

6           147.   After reviewing voluminous evidence and hearing days of testimony, the chair of  
7   the Senate Permanent Subcommittee on Investigation concluded that S&P intentionally delayed  
8   implementing a new version of CDO Evaluator:

9           In the summer of 2005, S&P had revamped its CDO model, but put the model on  
10   hold for more than a year, as it struggled to rationalize why it would not use the  
11   new model to retest existing CDO securities. It is clear from over a year of  
12   internal emails that S&P delayed and delayed the decision, anticipating that the  
13   revised model would require existing CDO securities to be downgraded, disrupt  
14   the CDO market, and reduce public confidence in its CDO ratings. It would have  
15   also disrupted S&P profits from CDO ratings.

16          148.   S&P quantitative analyst Kai Gilkes wanted a CDO model that would produce  
17   more accurate ratings. However, his recommendations to update the CDO model were rejected  
18   due to S&P’s concerns about how the revisions would affect S&P’s existing ratings, the market,  
19   and S&P’s place in the market.

20          149.   S&P also repeatedly yielded to pressure from CDO issuers to grant an  
21   “accomodat[ion]” if a proposed deal did not pass under the CDO Evaluator model. An  
22   “accomodat[ion]” made one time often turned into further exceptions down the road. In August  
23   2006, for example, an S&P managing director and Client Value Manager admitted to an issuer  
24   seeking more exceptions, “[h]ow many times have I accommodated you on tight deals?,” noting  
25   too that the issuer had also pressured another S&P employee to do the same.

26          150.   In 2005, S&P senior managing directors “toned down and slowed down” the  
27   release of CDO Evaluator 3.0 because it would drive away business. One of S&P’s major clients,  
28   Bear Stearns, had complained to S&P that CDO Evaluator 3.0 “would not be conducive towards  
29   rating low credit quality pools.” According to a July 2005 memo from Pat Jordan to Joanne Rose,  
30   the head of Structured Finance, “Bear Stearns pointed out that the potential business opportunities  
31   we would miss by effectively having to walk away from such high yield structures would NOT be

1 compensated for by any increases in rating volume for highly rated collateral pools.” (Original  
2 emphasis.) The memo continued, that as a result, S&P had “toned down and slowed down [its]  
3 roll out of E3 to the market, pending further measures to deal with such negative results.”

4 151. Mr. Gugliada later confirmed that he and David Tesher both resisted CDO  
5 Evaluator updates because they would have had a significant negative effect on S&P’s market  
6 share and ratings business.

7 **D. S&P Diluted Its CDO Evaluator Model to Expand Its Market Share**

8 152. Even when S&P developed an updated CDO Evaluator model, S&P deliberately  
9 used a diluted version of the model so as not to disrupt its business. This version was known as  
10 the “E3 low” model.

11 153. In June 2005, in an email to S&P analyst Michael Drexler, an S&P analyst Kai  
12 Gilkes lamented the corruption of the CDO model, instead of properly updating the model,  
13 stating:

14 Remember the dream of being able to defend the model with sound empirical  
15 research? The sort of activity a true quant CoE should be doing perhaps? If we  
16 are just going to make it up in order to rate deals, then quants are of precious little  
value.

17 154. Yet, S&P was unwilling to update these models fully because market sentiment  
18 about these improvements was “scary,” according to Mr. Drexler.

19 155. In addition, fears of the impact on already rated deals stifled even discussion of  
20 improving S&P’s CDO rating process. According to Mr. Drexler in the June 2005 email above,  
21 “the surveillance question” (i.e., whether and how to apply an improved CDO model to  
22 previously rated deals) continued to “haunt the dreams of NY management” to such a degree that  
23 Tom Gillis, the chief criteria officer for S&P was “pissed” and “refuses to accept any of the  
24 surveillance proposals.” Three months later, the head of the Global CDO group instructed her  
25 staff that testing of CDO Evaluator 3.0 should not begin until the surveillance question was  
26 answered.

27 156. The improvements Mr. Gilkes had inquired about included a long delayed update  
28 of Genesis. Genesis was used with Evaluator for rating cash flow CDOs. Genesis consisted of an



1 Excel spreadsheet built several years before, which according to a 2005 description of S&P's  
2 CDO Business suffered a number of "shortcomings/gaps" including "not comply[ing] with  
3 technology standards," and required "complete rebuilding."

4 157. In October 2005, the head of S&P's strategic planning group, Henry Carrier,  
5 directed his staff not to circulate an analysis of the problems with S&P's CDO's rating models.  
6 That analysis described one CDO process as "a crude patch," criticized the "poor integration" of  
7 CDO Evaluator and Genesis, and concluded that it was "readily apparent that we do not have the  
8 data or systems in place to be able to conduct large scale analysis in a timely manner."  
9 Inefficiencies and delays from implementing these proposed improvements further prolonged the  
10 corruption of the CDO ratings and surveillance processes.

11 158. Mr. Wong – a CDO Client Value Manager - later characterized the continuing  
12 corruption of S&P's CDO model in unmistakable words: "Lord help our f\*\*king scam."

13 **E. S&P Applied Fanciful Correlation and Related Criteria to Keep Ratings**  
14 **High**

15 159. Asset correlation is one of the key factors that determines the credit rating of most  
16 structured finance securities. Correlation measures how assets in a structured finance security  
17 perform together. For example, in rating CDOs, a correlation of 0% indicates that there is no  
18 connection between the risk that one loan in a pool will default and the risk that another will. Put  
19 differently, a correlation risk of 0% means each asset can be measured in isolation and the default  
20 of a single asset does not change the overall riskiness of the pool. By contrast, a correlation of  
21 100% between two assets means that if one asset performs poorly there is a 100% chance that the  
22 other one will too.

23 160. Other things being equal, the lower the correlation between the underlying assets  
24 of a structured finance security, the less risky that security is — and the higher rating it should  
25 receive. S&P deliberately avoided using accurate correlation assumptions to appease security  
26 issuers, and thus boost S&P's revenue. Rather than providing "investors with the independent  
27 benchmarks they need to feel more confident about their financial and investment decisions,"  
28

1 S&P intentionally gave them unreliable benchmarks by, for example, using inaccurate correlation  
2 assumptions to give investors a false confidence in the securities peddled by S&P's clients.

3 161. For example, in February 2005, trying to argue for more rigorous correlation  
4 assumptions, "compared to the shenanigans" before then, one S&P analyst pointed out that  
5 "[b]oth [Moody's and S&P] are wrong: The historical data also shows us definitively that  
6 correlation is not static, as our modeling suggests, but changes dynamically (i.e. increases in  
7 times of stress)." Another analyst resisted, responding "I don't want to miss one deal because of  
8 our model assumptions."

9 162. On March 20, 2006, a senior managing director of another company warned a  
10 senior director at S&P that "I mentioned to you a possible error in the new [CDO] Evaluator 3.0  
11 assumptions: Two companies in the same Region belonging to two *different* local Sectors are  
12 assumed to be correlated (by 5%), while if they belong to the *same* local Sector then they are  
13 *uncorrelated*. I think you probably didn't mean that." Two months later, the outside director  
14 followed up again with S&P. Finally, an S&P director admitted even though there may be a  
15 problem with S&P's correlation assumptions, the issue would not be addressed until "the next  
16 time [S&P] change[s] correlation assumptions."

17 163. The lack of proper correlation criteria infected the rating of asset-backed securities  
18 ("ABS") in general, turning it too into guesswork. S&P knew it lacked appropriate correlation  
19 rates for ABS so it used a "blanket" approach by applying RMBS correlations to all ABS in a  
20 CDO. In November 2004, Stephen McCabe, S&P's lead quantitative analyst on the Cheyne SIV  
21 deal, e-mailed his manager that S&P's default rates on ABS transactions were purely guesswork:  
22 "from looking at the numbers it is obvious that we have just stuck our preverbal[sic] finger in the  
23 air!"

24 164. In September 2004, fearing a loss of ABS rating market share, Perry Inglis, an  
25 S&P managing director in Structured Finance and head of the group that rated the Cheyne SIV,  
26 decided to use weaker correlation criteria that were based on ratings of corporate assets – despite  
27 knowing that ABS was not diversified enough to support an AAA rating:  
28

1 [C]an we perhaps have a chat about this when we get back as we do have new Default  
2 Tables and correlation assumptions for corps and it would be good to get an idea of  
3 how far these would have to change for us to be "competitive" on these types of  
4 deals. I'm a bit unclear if is a big change or a 'wee itty bitty no-one's going to notice'  
5 change!

6 165. In an internal email dated May 23, 2007, an S&P credit analyst suggested that  
7 assets in static CDOs (i.e., CDOs whose pools of assets could not change over the life of the  
8 CDO) were subject to inadequate stress testing because S&P applied similar default rates to CDO  
9 assets without adjusting for riskier assets with more problems. In response, the S&P senior  
10 director wrote that "I would recommend we do something. Unless we have too many deals in US  
11 where this could hurt" – demonstrating that, while S&P was aware that it did not model  
12 correlation risk properly, it would not change its correlation assumptions due to the business  
13 impact such changes may have.

14 166. The flawed correlation assumptions used with S&P's CDO ratings also tainted  
15 correlations used for S&P's SIV ratings. S&P was fully aware that the correlation assumptions it  
16 used for CDO Evaluator were also applied to its correlation assumptions for SIVs. For example,  
17 a June 2005 training package presented to S&P SIV employees explained that SIV "correlation  
18 assumptions [are] consistent with those from CDO Evaluator."

19 167. When it suited S&P's market share goals, S&P even assumed there was "zero"  
20 correlation between assets with a common component. For example, two S&P analysts discussed  
21 in an April 2007 email that despite knowing a zero correlation assumption would leave a gap in  
22 the needed assumptions large enough for a "Mack truck to drive" through, S&P still decided to  
23 adopt a correlation of zero between a "CDO of ABS asset and an RMBS asset in a CDO/ABS  
24 transaction." One analyst also confirmed that senior S&P CDO management "clearly knew" of  
25 this practice and that the head of the CDO group was "responsible." In short, this risky  
26 assumption further caused ratings of such correlated assets to be too high.

27 168. Other criteria like "default tables" were also weakened as necessary to allow  
28 inflated ratings. For example, according to July 2004 minutes of a meeting of senior CDO  
management, senior management knew that more accurate default tables would not be allowed if  
doing so drove away market share because the "subordinate mezzanine tranches are very sensitive

1 to ratings and that any slight change to the required credit support to the B- or BB pools would be  
2 problematic and could impact our CDO of CDO business.”

3 **F. S&P Intentionally Ignored the PIK Stress Test**

4 169. To please issuers, S&P simply ignored another CDO criterion, the payment-in-  
5 kind (“PIK”) stress test. Some assets underlying a CDO allowed for riskier payment-in-kind  
6 tranches. “Payment-in-kind” meant that the manager of the CDO could either pay investors the  
7 amount of their regular payment, or add the payment amount to the investors’ account. Yet, here  
8 too, in 2005, S&P admitted that “we ignore this test [on] so many deals.” The test at issue was a  
9 PIK stress test for CDOs.

10 170. At other times, S&P just “winged” it to rate deals. For example, in May 2007, an  
11 S&P analyst admitted “[I] am just going to wing it” while struggling to run PIK tests as part of  
12 rating two CDO Squared deals. In this case, the analyst was not able to pass the two deals  
13 because they kept failing the “PIK stress” test, which was still the “the furthest thing from clear.”

14 171. In short, even though S&P knew it did not have good default table, correlations, or  
15 other data for assets like RMBS, CDOs, CMBS or SIVs, it made up such data to rate them  
16 anyway. When S&P’s former Global Practice Leader for CDOs, Richard Gugliada, was asked,  
17 “[i]f you didn’t have the data, and you’re a data-based credit rating agency, why not walk away”  
18 from rating the CDO deals underlying SIVs, he responded: “*The revenue potential was too*  
19 *large.*”

20 **G. S&P’s Rating Committees Also Relaxed Their Criteria to the Point Where**  
21 **They Would Rate Even a Deal “Structured by Cows”**

22 172. S&P’s rating committees also did their part when criteria threatened business-  
23 friendly ratings. In April 2004, the co-manager of the CDO group, Dave Teshner, asked if any  
24 CDO committee had “forgiven certain cash flows runs that have failed . . . to ultimately arrive at a  
25 rating. . . .” Mr. Teshner was told “yes, we do forgive runs all the time in committees.”

26 173. Consistent with “forgiving runs,” S&P’s rating committees also circumvented the  
27 process spelled out in the criteria for the relevant security, and used backroom deals to arrive at  
28 inflated ratings and undocumented rating decisions. Rating committee participants knew ratings

1 were not justified, so preferred not to leave a paper trail. For example, in May 2005, the relevant  
2 rating committee for one CDO approved AAA and AA ratings, by a 4-to-3 vote, but the four  
3 "yes" votes were not in writing. The committee bypassed "established criteria on the  
4 requirements for counterparty ratings" and instead used "a way around the intent of [S&P's]  
5 counterparty ratings criteria." An S&P analyst characterized this end-around as:

6 a great example of how the criteria process is NOT supposed to work. Being out-  
7 voted is one thing (and a good thing, in my view), but being out-voted by mystery  
8 voters with no "logic trail" to refer to is another. How can we possibly reconstruct  
9 the argument of the winning side for future deals if it does not exist in writing for  
general reference? Also, it is not clear that this decision will be universally  
applied. Again, this is exactly the kind of backroom decision-making that leads to  
inconsistent criteria, confused analysts, and pissed-off clients.

10 174. In April 2007, two S&P analysts described how bad the criteria had become,  
11 acknowledging that they should not be rating a "ridiculous" deal but concluding "it could be  
12 structured by cows and we would rate it."

#### 13 **H. S&P Intentionally Ignored Its Own Rating Policy for CDOs of RMBS**

14 175. S&P often rated cash and hybrid CDOs that were still incomplete when rated. The  
15 issuers wanted ratings before they had finished assembling the assets for these CDOs, and S&P  
16 was happy to oblige. It would rate these unfinished CDOs based on a mix of actual assets in the  
17 CDOs and "dummy" assets that were designated by type, rating, maturing date, and size, but had  
18 not yet been purchased. From the time of closing, the issuer had a three to six month window to  
19 finish purchasing all of the underlying assets, after which S&P promised to update its rating of the  
20 CDO and issue a notice containing the final credit rating notice of the CDO. This notice was  
21 called "Effective Date Rating Agency Confirmation" ("RAC"). The RAC letter was supposed to  
22 confirm the ratings issued at closing, after all the underlying assets of the CDO had been  
23 purchased and analysis had been done on those assets to make sure they still deserved the rating  
24 originally given. However, S&P often failed to do the necessary analysis to make the  
25 representations contained in RAC letters.

26 176. For example, for CDOs that closed in March 2007 (when S&P still used the  
27 LEVELS 5.7 model) any underlying assets replacing dummy assets during the Ramp-up Period in  
28 May or after needed to be analyzed under the new LEVELS 6.0 model. If the assets analyzed

1 under the stricter 6.0 model had to be downgraded, S&P would not have been able to issue a RAC  
2 letter. However, S&P failed to use the new version of LEVELS 6.0 on these RMBS, but  
3 nonetheless issued RACs for the CDOs.

4 177. On July 18, 2007, S&P announced that it would “notch” its own ratings on certain  
5 underlying non-prime RMBS assets when rating CDOs due to the potential for further  
6 downgrades. “Notching” required S&P to drop its rating of the RMBS one level (e.g., from AAA  
7 to AAA-) when calculating the rating of the CDO in which the RMBS was contained. The  
8 purpose of this policy was to assure the investment community that S&P had factored in the  
9 possibility of RMBS downgrades when rating CDOs. However, S&P chose not to apply the  
10 notching criteria to all CDO deals. In fact, S&P analysts were told by management not to apply  
11 the notching criteria to recently created CDOs that had not yet received a RAC. The analysts  
12 were directed to rely on the existing underlying RMBS ratings in writing the RAC – even though  
13 S&P knew many of those RMBS were under review for downgrade.

14 178. Thus, S&P deliberately ignored its publicly announced RAC policy so that it could  
15 issue a few more inflated CDO ratings before the bubble finally burst. This also further  
16 diminished the value SIVs that were backed by these RMBS or CDO assets.

17 **I. S&P Also Used “Arbitrary” Tricks and “Tweaks” to the CDO Model to**  
18 **Preserve Its Market Share of CMBS**

19 179. While S&P knew in 2005 that there were concerns of a “bubble” in the CMBS,  
20 RMBS, and CDO sectors, S&P’s top analysts also knew that S&P’s modeling of CMBS was  
21 defective, and that here too S&P was resorting to “tweaks.” PERS invested in SIVs holding  
22 CMBS assets.

23 180. In June 2005, just two months before the issuance of the Cheyne SIV, the senior  
24 S&P executive in charge of CMBS knew that S&P was “in desperate need of a more robust  
25 default and loss model [to] calculate credit support” for CMBS. Furthermore, “Moody’s and  
26 Fitch [had] become very competitive and the volume of these deals [had] increased significantly.  
27 If we were using Evaluator in its current state without the tweaks, we would not be rating these  
28 deals right now. As you know, if we don’t rate the CDOs, we will lose the primary deals as

1 well.” In response, S&P’s Kai Gilkes expressed concern about the effectiveness of S&P’s ratings  
2 of CMBS within CDOs to capture market share: “I am keen to understand what the competition is  
3 doing for these deals. . . . I agree that CDO Evaluator is not the best solution, and arbitrary  
4 tweaks to the assumptions may be dangerous in the long run” because they may lead to inaccurate  
5 ratings.

6 181. An internal 2006 study confirmed again that the default tables of the CDO  
7 Evaluator were still not “conducive” for rating CDOs of CMBS. Instead of developing a proper  
8 model, S&P used an outdated version of Evaluator for such ratings. Since the outdated Evaluator  
9 failed to capture key information about CMBS deals, S&P used “outside-the-model” adjustments,  
10 which led to “inconsistencies” of ratings.

11 182. Despite these concerns, even as late as April 2007 S&P continued to use an  
12 inadequate and obsolete CMBS rating model. An S&P presentation listed the problems still  
13 plaguing the CMBS rating model. The CMBS model could not adequately support the CMBS  
14 ratings business. The model also did not allow for adequate surveillance of CMBS.

15 183. As with other types of securities, S&P’s paramount goal of protecting its turf  
16 trumped improving its CMBS rating process. In 2006, S&P’s highest managers and executives  
17 had coordinated this strategy of weakening the rating model for CMBS – a strategy presented to  
18 S&P’s President Corbett:

19 Fitch and Moody’s have recently liberalized their criteria for rating real estate  
20 CDOs. Implication: If S&P requires higher credit support levels than the other  
21 rating agencies, we will likely lose rating mandates and our dominant market share  
22 position. . . .

23 Members of the CDO group, the CMBS group and SFLT are working on revisions  
24 to E3 [Evaluator 3] in an effort to avoid a decline in S&P’s market share primary  
25 CMBS rating resulting from the rollout of the new evaluator for cash deals. . . .

26 **J. S&P Viewed Its Ratings Models as a “Mousetrap” to Achieve Favorable**  
27 **Ratings and Maintain Market Share**

28 184. In a September 2006 Monthly Activity Report for the CDO group, the head of the  
CDO group informed Joanne Rose that S&P had already begun working with an outside  
consultant to develop a “new-generation default matrix” that would give S&P “more flexibility in  
formulating a business driven default matrix.”

1           185.    An April 2007 S&P presentation revealed how far S&P progressed in a model it  
2 was now proposing to create a “better mousetrap” to rate asset-backed securities by starting with  
3 the desired business friendly ratings, then working backwards. A flowchart illustrated the  
4 business focus, showing “[t]he old way was ‘a one way street’ where S&P would start with data,  
5 calculate ‘idealized’ probabilities of default, then ask ‘does this work for our ratings business? If  
6 not, the default probabilities would need to be “tweaked.”’ The newest “better mousetrap”  
7 proposal, or the “two way street,” simply started with the desired business outcome. If the data  
8 did not lead to the desired business outcome, then S&P simply “use[d] another set” of default  
9 probabilities. The “better mousetrap” presentation further explained that:

10           [New methodology] . . . We decide on a number of business friendly PD matrices  
11           first. Statistical Hypothesis testing allows us to test if our first trial-and-error set is  
12           reasonable. If it is not, we can try another or many other matrices.

13           186.    The “better mousetrap” presentation was shared with the directors of S&P’s CDO  
14 ratings group on May 10, 2007, informing them that the new CDO model approach could be used  
15 for any rating or matrix.

16           187.    In August 2007, Mr. Wong updated senior executives of S&P’s CDO group on the  
17 “better mousetrap” approach, stating:

18           I believe it is worth pointing out that while the initial project did focus on  
19           Hypothesis Testing to buy us the operational freedom to defend multiple business  
20           friendly default matrices, the single first step in coming up with a Hypothetical  
21           default matrix to be tested (i.e. where do we begin?) itself is based on Maximum  
22           Likelihood Estimation (i.e. Bu couldn’t really pull it out of thin air like we did  
23           with CDOE3.2) . . . . We then “bend” this transition matrix to suit our business  
24           needs. (Emphasis added.)

25           188.    A month later, Mr. Wong confirmed again to the senior executive in charge of the  
26 CDO group that the better mousetrap method would “allow us for business reasons to deviate  
27 from an ABS default matrix that is estimated from history.” S&P stopped this high-level  
28 formalization of its existing practices only after the collapse of the CDO markets in later 2007.

**K.   S&P Failed to Disclose Its “House-of-Cards” Ratings Process for CDO-  
Related Securities**

189.    As discussed above, S&P’s models for RMBS, CDOs, CMBS and related assets  
were corrupt. The corruption of S&P’s CDO model and rating process was compounded in



1 S&P's rating of CDO Squared or "CDO2" transactions, where the underlying assets were  
2 themselves tranches of CDOs composed of RMBS tranches rated by S&P. The same was true for  
3 CDOs that reference RMBS or derivative RMBS tranches rated by S&P. The SIVs that PERS  
4 invested in included such assets. Because of the corruption of both the RMBS and CDO models  
5 and processes, the ratings for these additional CDO transactions were built on an even weaker  
6 foundation of sand.

7 190. Instead of informing the public about its "scam" or limiting the CDOs it rated,  
8 S&P knowingly continued to conduct "business as usual" – maintaining the facade that it issued  
9 independent, objective, and reliable CDO ratings. As the Associate Director of S&P's Global  
10 CDO Group noted to a senior director at S&P in December 2006:

11 [R]ating agencies continue to create and [sic] even bigger monster- the CDO  
12 market. Let's hope we are all wealthy and retired by the time this house of cards  
falters. ;o).

13 **L. S&P Ignored Its Own Warnings About the "Powder Keg" Mortgage**  
14 **Market**

15 191. The Senate Permanent Subcommittee on Investigations also concluded that S&P  
16 knew that there were:

17 problems in the mortgage market, including an unsustainable rise in housing prices,  
18 the high risk nature of the loans being issued, lax lending standards, and rampant  
19 mortgage fraud. Instead of using this information to temper their ratings, S&P  
20 continued to issue a high volume of investment grade ratings for mortgage backed  
21 securities. If S&P had issued ratings that accurately reflected the increasing risk in  
the RMBS and CDO markets and appropriately adjusted existing ratings in those  
markets, it could have discouraged investors from purchasing high risk RMBS and  
CDO securities, and slowed the pace of securitizations.

22 192. For example, in 2006, S&P personnel knew about the deteriorating performance of  
23 RMBS loans but failed to act. Instead, as observed by the head of S&P's Servicer Evaluations for  
24 North America, S&P had "become so beholden to their top issuers for revenue they have all  
25 developed a kind of Stockholm syndrome which they mistakenly tag as Customer Value  
26 creation. . . ." This was in response to an email by an S&P structured finance ratings managing  
27 director who described relations with one issuer as "uncomfortably cozy" despite the fact that  
28

1 "there has been rampant appraisal and underwriting fraud in the industry for quite some time as  
2 pressure has mounted to feed the origination machine."

3 193. In September 2006, the Director of Servicer Evaluations wrote that the head of  
4 U.S. RMBS Surveillance told him losses in home loans were in the "high 40s – low 50s %" and  
5 that he agreed the cause to be "underwriting fraud; appraisal fraud and the general appetite for  
6 new product among originators is resulting in loans being made that shouldn't be made" which  
7 "could be a RICO offense!" The Director also wanted to publish a commentary to disclose the  
8 high losses he was warned about, but realized this would "too much of a powder keg." Yet, S&P  
9 ignored this warning.

10 194. S&P also learned in September of 2006 that ARM loans – which S&P had failed  
11 to model properly in LEVELS – were already "nightmare mortgages." Thus, one S&P personnel  
12 emailed that "this is frightening. It wreaks of greed, unregulated brokers, and 'not so prudent  
13 lenders' . . . . Hope our friends with large portfolios of these mortgages [were] preparing for the  
14 inevitable." Again, S&P ignored this warning.

15 195. A month later, in October 2006, S&P managing director confirmed that news of  
16 deteriorating home loans was "[p]retty grim as we suspected . . . I think things are going to get  
17 mighty ugly next year!" S&P ignored this warning.

18 196. Not until March of 2007, when many of the deals rated by S&P were collapsing,  
19 did S&P stop ignoring its own warnings. An RMBS Group presentation to President Terry  
20 McGraw of McGraw-Hill Companies and his "executive committee" discussed the subprime  
21 "brou haha reaching serious levels . . . and how we rated the deals and are preparing to deal with  
22 fallout (downgrades)."

23 197. In February 2007, S&P director Frank Parisi informed senior management that  
24 losses for 2006 vintage subprime RMBS deals could be one and half to two times as high as  
25 losses for 2000 vintage deals. Dr. Parisi had studied the different vintages because the head of  
26 U.S. RMBS surveillance had expressed concerns about deteriorating RMBS conditions in 2006.

27 198. In March 2007, the President of S&P was also informed that the subprime "2006  
28 vintage being only 50% more risky than 2000 vintage ma[y] understate the risk." Notebook

1 entries of data prepared for S&P EVP Vickie Tillman a day later state that more than half of BB+  
2 and BB were “expected to take some loss” – an exceptionally high loss rate.

3 199. Also in March 2007, an instant message exchange between two S&P analysts  
4 captured the “gist” of senior management warnings that the “market will crash.” Yet as last-  
5 minute deals rushed in, analysts were told to “be cooperative” and not “push criteria” that got in  
6 the way of closing deals before the crash.

7 200. Again, in April 2007, an S&P analyst warned that default numbers for BBB and  
8 BBB- 2005 and 2006 subprime RMBS were substantially higher than previously predicted. S&P  
9 continued to disregard warnings that would interfere with rating as many RMBS as possible to  
10 capture maximum revenues.

11 201. When S&P finally took action, a director of the Servicer Evaluations team,  
12 responded that S&P “[s]hould have been doing this all along.” However, S&P did too little, too  
13 late.

14 **M. S&P Also “Grandfathered” RMBS and CDO Deals Using Different**  
15 **“Tricks” to Avoid Losing Market Share**

16 **1. S&P refused to apply more accurate rating models or information to**  
17 **re-rate already rated RMBS**

18 202. Despite the warnings of deteriorating loan market conditions, the senior manager  
19 overseeing S&P’s RMBS surveillance group simply refused to apply updated models to existing  
20 ratings on deals – a practice referred to as “grandfathering” – and was pressured by upper  
21 management not to re-rate these deals using the updated model. The reason S&P did so was  
22 simple: it did not want to upset the issuers of the grandfathered securities. If S&P had done  
23 otherwise, many securities would have been put on Credit Watch or been downgraded as early as  
24 2005, causing major headaches for their issuers.

25 203. S&P was also motivated to continue grandfathering to match Moody’s. S&P  
26 knew that Moody’s was grandfathering its previous ratings on deals even though Moody’s  
27 publicly said it was not doing so. In March 2006, the head of European Structured Finance at  
28 S&P, Ian Bell, met with his counterpart at Moody’s and then emailed top executives at S&P  
about what Moody’s revealed to him:

1 FYI. Just sat on a panel with Frdric Drevon, my opposite number at Moody's who  
2 fielded a question on what happens to old transactions when there is a change to  
3 rating methodologie [sic]. The official Moody's line is that there is no  
4 "grandfathering" and that old transactions are reviewed using the new criteria.  
5 However, "the truth is that we do not have the resources to review thousands of  
6 transactions, so we focus on those that we feel are more at risk." Interestingly,  
7 Olivier Dufour from Fitch said they "grandfathered" as it would otherwise be  
8 "unfair."

9 204. In May 2006, S&P represented to its Structured Finance Investor Council that  
10 "S&P Structured Finance does not refer to the term 'grandfathering' when discussing the impact  
11 that implementation of new criteria may have on existing ratings." Despite this representation, a  
12 June 23, 2006 email chain about a minor revision to the LEVELS model reveals how S&P's top  
13 RMBS Client Value Manager and other senior executives rationalized their decision to secretly  
14 "grandfather" existing ratings while claiming to do the exact opposite:

15 Simply put – although the RMBS Group does not "grandfather" existing deals,  
16 there is not an absolute and direct link between changes to our new ratings models  
17 and subsequent rating actions taken by the RMBS Surveillance Group. As a result,  
18 there will not be wholesale rating actions taken in July or shortly thereafter on  
19 outstanding RMBS transactions, absent a deterioration in performance and  
20 projected credit support on any individual transaction.

## 21 2. S&P also grandfathered CDO securities

22 205. A June 2005 email showed that grandfathering was the "overarching" reason S&P  
23 delayed releasing updates to its CDO Evaluator model (ultimately CDO Evaluator 3.0), since  
24 using the updated model on all the deals could significantly disrupt its business.

25 206. In July of 2005, S&P was desperate to find a "trick" to avoid using its updated E3  
26 model to re-rate previously rated CDO deals. In keeping with S&P's foremost strategic goal of  
27 protecting its turf, rather than accurate ratings, an S&P CDO analyst, who was also a Client Value  
28 Manager, explained that "[t]he trick is of course to minimize impact on deals."

29 207. S&P came up with just such a trick a few months later. Instead of properly  
30 analyzing the relevant underlying data of a deal, S&P would test out certain "tolerances" to  
31 achieve the desired business-friendly result. In November 2005, S&P proposed and eventually  
32 used a mix of "tolerances" with a new rating model combination called E3/Low and E3/High.  
33 E3/Low was a more permissive rating alternative model that would allow AAA ratings on more

1 deals. S&P's goal was not to re-rate deals accurately but to ensure that S&P's high market share  
2 was not disrupted when a prior deal had to be re-rated. S&P would also minimize disclosing the  
3 results of these tricks to issuers.

4 208. Of course, if investors knew that S&P was deliberately rating deals using obsolete  
5 models to keep issuers happy, they might cease to rely on those ratings. So S&P did not fully  
6 disclose what it was doing, and created confusion even when it disclosed some of its  
7 grandfathering practices – in direct contradiction to its promise to conduct ratings and  
8 surveillance in a “transparent and credible” manner.

9 209. For example, in December 2005, S&P senior executives were reminded that S&P's  
10 confusing grandfathering practices surrounding the release of CDO Evaluator 3.0 still required  
11 creating “a policy framework” that would disclose clearly when S&P would grandfather new  
12 transactions. Without that policy framework, S&P was “not being as transparent as we need to  
13 be” in the market. The senior executives had been warned of the need to create this framework  
14 months before, but had failed to implement it. Later, in early 2006, S&P's CDO leader, David  
15 Teshler, confirmed that the “tolerance bands still “created confusion given their lack of  
16 transpar[e]ncy.”

17 **N. S&P Starved Key Rating and Monitoring Groups of Staff and Needed**  
18 **Resources as an Excuse to Avoid Losing Business**

19 210. S&P's post-rating practices were no better than its rating practices for new  
20 securities. Just as S&P had weakened the rating process to increase its profits and market share, it  
21 also corrupted the surveillance of those ratings.

22 211. S&P's representations that it would use relevant, reliable, and up-to-date analytics  
23 in monitoring its credit ratings were false. S&P failed to maintain robust surveillance practices  
24 that would, as represented, ensure that ratings continued to reflect their credit assessment.

25 212. S&P's Surveillance Group “only re-review[ed] a deal under new  
26 assumptions/criteria when the deal is flagged for some performance reason.” In other words,  
27 regardless of how risky S&P suspected a security might be, the security would not be re-rated so  
28 long as it continued to perform (such as make payments on time). An S&P managing director of

1 surveillance explained that "[t]he two major reasons why we have taken the approach is (i) lack  
2 of sufficient personnel resources and (ii) not having the same models/information available for  
3 surveillance to relook at an existing deal with the new assumptions (i.e. no cash flow models for a  
4 number of assets). The third reason was concerns over how disruptive wholesale rating changes,  
5 based on a criteria changes, can be to the market."

6 213. Even when Surveillance tried to update some of the deals, it was thwarted by  
7 management's desire to maintain its market share. In late 2006, Ernestine Warner, the head of  
8 RMBS Surveillance, complained to a senior executive on a weekly basis of not being able to  
9 downgrade the subprime RMBS as necessary. Her complaint was that Tom Gillis, the Chief  
10 Quality Officer, ignored her requests because of business reasons.

11 214. But instead of quickly adapting to dramatically changed circumstances, an ongoing  
12 and "often heated" discussion resulted when Mr. Raiter, former head of RMBS, tried to persuade  
13 the surveillance group to use updated models. The Surveillance Group would not use the updated  
14 models.

15 215. It was only after numerous deals started to default that S&P was forced to take  
16 action. By the end of April 2007, the Surveillance Group finally began moving away from using  
17 outdated models. For instance, on 2005 vintage securities, the Surveillance Group began to apply  
18 newer methods that identified deals at risk of downgrade before significant realized losses.

19 216. Had S&P fulfilled its promise to "updat[e] on a timely basis the rating, as  
20 appropriate" beginning in 2004, Mr. Raiter, testified that "we might not have had to wait until  
21 2007 for the poor performers to come to light. Again, had the best practices been in place, some  
22 of the worse performing products might have been extinguished before they grew to such a size  
23 that they disrupted financial markets." However, due to (a) concerns about ratings volatility and  
24 potential loss in revenue, and (b) the fact that S&P failed to give proper attention to the long-  
25 standing problem of inadequate resources in the Surveillance Group, the new modeling to review  
26 the performance of outstanding ratings was not timely implemented by management of the  
27 Surveillance Group.

1           217. As of June 2005, the SFLT knew from S&P's 2006 Strategic Plan that its RMBS,  
2 CDO and CMBS groups were "not currently staffed or resourced to meet the demands." The  
3 2006 Strategic Plan also warned SFLT that a "bubble" was developing in the CMBS, RMBS and  
4 CDO sectors, and a bubble burst would cause a "large number of rating downgrades" and "high  
5 negative rating volatility."

6           218. The SFLT also knew from S&P's 2006 Strategic Plan that "the effect of reduced  
7 timeliness of [RMBS] surveillance as a result of resource demands for new ratings, will increase  
8 notching for rating changes, impact the integrity of our transition studies and market perception."  
9 Still nothing was done to meet the surveillance resource needs.

10           219. The CDO Ratings Group also knew it too was severely understaffed. In December  
11 2005, for example, efforts to address staffing needs in the CDO area were inadequate. S&P's  
12 CDO Ratings Group was still looking for ways "to achieve a state where the departure of 1 or 2  
13 quants [quantitative analyses] (especially junior quants) does not impact our business severely as  
14 is the case today."

15           220. In October 2006, the head of S&P's CDO Ratings Group warned the head of the  
16 Structured Finance Division about the harm from insufficient staffing. She wrote about the  
17 revenues and numbers being the priority over service: "While I realize that our revenues and  
18 client service numbers don't indicate any ill [e]ffects from our severe understaffing situation, I am  
19 more concerned than ever that we are on a downward spiral of morale, analytical leadership/  
20 quality and client service." This warning followed another a month before – in a report between  
21 the same two senior executives – about future calamities looming ahead: "the cooling of the  
22 housing market is inevitable and the deterioration of the RMBS market and the financial health of  
23 mortgage lenders and builders remain on every market participant's mind."

24           221. In late 2006, the RMBS Surveillance unit was in clear need of staffing help, and  
25 management knew it but did nothing. The Surveillance unit needed more staff to rate 863 deals,  
26 in addition to the "back log of deals that are out of date with regard to ratings." This urgent  
27 request for staffing was not addressed by S&P and therefore the "big backlog of work for RMBS  
28 surveillance" was still apparent in 2007.

1           222. While these events were happening, S&P represented to its Structured Finance  
2 Investor Council in November 2006, that "S&P has an integrated surveillance process to ensure  
3 that RMBS assets in CDOs of ABS are appropriately monitored and reflect Standard & Poor's  
4 most current credit view.

5           223. By January 2007, at an RMBS Surveillance team meeting headed by Ernestine  
6 Warner (the senior director of U.S. RMBS Surveillance), the team observed that a housing bubble  
7 existed, with a default projection of 20 percent. The team observed that for deals rated A and  
8 below, 80 percent of them were in "trouble." Given this environment, the Surveillance team's  
9 plan for handling credit watch issues was to identify all the worst pools of 2006 (after setting a  
10 cutoff point for delinquencies at 20-30 percent) and place them all on Credit Watch with negative  
11 implications.

### 12 **III. REASONS FALSE AS TO SIVs**

13           224. With respect to SIVs, there were two basic areas where S&P's ratings proved  
14 false: (1) the ratings of the SIVs and their securities, and (2) the ratings of the assets the SIVs  
15 purchased. As described below, S&P failed to comply with its publicly announced standards in  
16 both of these areas.

#### 17 **A. S&P Inflated the Ratings of the SIVs and the Securities They Issued**

##### 18 **1. S&P failed to rate the SIVs independently and objectively as** 19 **required by its public rating methodology and criteria**

20           225. S&P stated, "To be confident that the [SIV's] senior liabilities are able to maintain  
21 the highest possible ratings until maturity, Standard & Poor's measures capital adequacy on the  
22 basis that the vehicle enters into immediate wind-down, sometimes referred to as 'defeasance' or  
23 'enforcement.' The question that arises therefore is this: if the SIV enters into defeasance or  
24 enforcement today, can it sell its assets and repay its liabilities such that the level of capital in the  
25 vehicle at the time of the defeasance is sufficient to maintain the 'AAA/A-1+' rating on those  
26 liabilities until they are repaid in full or have matured...?" S&P represented that under the  
27 scenarios tested, the senior liabilities would be repaid in full by the SIVs. Those representations  
28 were false.



1           226. In reality, S&P gave the SIVs and their securities ratings that it knew they did not  
2 deserve. S&P's SIV rating model did not operate as represented. Instead, S&P assumed that the  
3 SIV would face unrealistically low fire-sale discounts in these circumstances. S&P also failed to  
4 account for the possibility that other SIVs would also be selling off their assets at the same time,  
5 potentially flooding the market and further depressing prices. Rather, S&P assumed the SIV  
6 would be able to sell its assets for nearly 100% of their fair market value.

7           227. When the SIVs did in fact enter run-off, they were often lucky to get 50% of the  
8 market value of their assets, creating massive losses for PERS and other investors.

9           228. Furthermore, critical data that S&P used to rate the SIVs was either nonexistent or  
10 unreliable, and S&P knew it. For example, in 2004, an S&P analyst responsible for rating the  
11 Cheyne SIV (one of the SIVs at issue in this case) stated, "As you know, I had difficulties  
12 explaining 'HOW' we got to those numbers since there is no science behind it . . . and eventually  
13 I told him that we had to adjust in order to make committee comfortable with the peer  
14 comparison."

15           229. S&P also made ad hoc adjustments based on pressure from its client issuers. For  
16 example, S&P was pressured to adjust its capital buffer on the Cheyne SIV's capital notes. In  
17 2004, an S&P rating analyst for the Cheyne SIV articulated that S&P "[has] always been very  
18 cautious in making sure that the rating of the capital notes is extremely stable," especially because  
19 of "the impact that a minimum downgrade on the capital notes could have on the senior notes in  
20 terms of market perception." S&P initially advised that a 1% capital buffer was needed  
21 underneath the Cheyne SIV's mezzanine capital notes ("MCNs") to rate the capital notes up to  
22 BBB+. Although S&P stated that the 1% capital buffer was a "pillar of [its] analysis," S&P  
23 ultimately acquiesced to pressure from Morgan Stanley – the architect of the Cheyne SIV – and  
24 allowed Cheyne to reduce the buffer by 25%. In another example, when S&P's Lapo  
25 Guadagnuolo initially informed Morgan Stanley that the targeted A rating on the Cheyne MCNs  
26 was not possible and that S&P was willing to assign only a BBB to the Cheyne MCNs, a  
27 threatening email to S&P's Perry Inglis made "it clear that [Morgan Stanley] believe[s] the  
28 position committee is taking is very inappropriate." Again, S&P acquiesced to pressure from

1 Morgan Stanley and agreed to assign an A rating to the Cheyne MCNs (despite the lower capital  
2 buffer).

3 230. The Cheyne MCNs' A rating was also helped by S&P relaxing its criteria. S&P's  
4 rating analyst on the Cheyne SIV decided that "the step we needed to undertake in order to rate  
5 the capital notes was to assume a probability of enforcement of less than 100%. This 'relaxation'  
6 of our methodology would apply ONLY for capital notes seeking a rating up to 'A.'"

7 **2. S&P succumbed to issuer pressure when it ignored the lack of**  
8 **experience of the Cheyne SIV Manager**

9 231. S&P broke its own rules on behalf of its client issuers when it ignored the Cheyne  
10 SIV managers' inexperience. S&P had always insisted that the SIV manager was a key element  
11 in S&P's rating analysis. SIV managerial experience was important because SIVs – including  
12 Cheyne – were especially complex, in part because the SIVs held many changing different asset  
13 types over time. As one S&P manager put it, "... we will have to explain to the market that first  
14 time managers cannot achieve top ratings by S&P, regardless what the structure allows/does not  
15 allow them to do." (Emphasis added)

16 232. In mid-2004, Morgan Stanley, which happened to be one of S&P's biggest  
17 customers, requested an A rating from S&P for a key component of the Cheyne SIV. S&P  
18 advised Morgan Stanley that Cheyne's lack of managerial experience was one of the reasons that  
19 an A rating could not be given. However, after Morgan Stanley repeatedly pressured S&P, S&P  
20 amended its feedback and dropped its requirement of an experienced SIV manager.

21 233. In May of 2005, S&P again acquiesced to Cheyne's demands for an exception to  
22 the rules in spite of Cheyne's lack of track record as manager. Cheyne requested the same  
23 treatment as another SIV, Sedna, regarding breach of certain liquidity tests. When a SIV  
24 breached certain tests that measured the minimum amount of liquidity to be provided and did not  
25 cure the breach for more than 5 business days, an enforcement or defeasance action was initiated.  
26 Sedna was allowed to breach any of these tests once every year and not face  
27 defeasance/enforcement, provided it cured the breach within 10 business days. Cheyne wanted  
28

1 the same treatment as Sedna even though Sedna's managers had more experience. Yet S&P  
2 yielded even though Cheyne was a new manager without a track record.

3 **3. The SIVs collapsed because of risks S&P should have foreseen**

4 234. By late 2007, the market for SIV notes evaporated. As the same time, asset prices  
5 fell and the SIVs began to go into defeasance as a result. As they went through defeasance and  
6 sold off their assets, the truth about the quality of those assets began to be revealed. Because of  
7 the low quality of the assets in the SIVs' portfolios (despite AAA ratings from S&P), the SIVs  
8 had to sell assets at substantial discounts. Exacerbating this problem, multiple SIVs were selling  
9 their assets at the same time, driving the market prices for them still lower. And because these  
10 sales were involuntary, the SIVs were forced to take additional "fire sale" discounts. All of these  
11 developments were foreseeable, but S&P either unreasonably minimized their impact in its model  
12 or failed to account for them entirely.

13 235. The collapse of many of the SIVs happened in a matter of weeks. S&P did not  
14 downgrade the ratings on the SIVs, let alone put the SIVs on negative watch, until shortly before  
15 the SIV structures collapsed into dissolution. Holders of senior SIV securities, including PERS,  
16 sustained major losses.

17 **B. S&P Inflated the Ratings of the Securities Held by the SIVs**

18 236. Compounding the problems in the ratings of the SIVs themselves and the  
19 securities they issued, S&P knowingly corrupted the ratings of the securities in which the SIVs  
20 invested. Those securities provided the funds that the SIVs used to pay investors such as PERS,  
21 so flaws in those ratings directly affected the riskiness of PERS's investments in SIV securities.  
22 Those fraudulent ratings also proximately caused PERS's losses on SIV securities because the  
23 SIVs took massive losses when they were forced to sell their assets, and they passed those losses  
24 along to PERS and other investors.

25 **1. Defects in the RMBS held by SIVs**

26 237. The defects in S&P's RMBS ratings are discussed in detail above. Those defects  
27 infected most or all of the S&P-rated RMBS held by the SIVs in which PERS invested.  
28

1                   2.     **Defects in the CDOs and other assets held by SIVs**

2           238.   As noted above, CDOs, CMBS, and ABS were also significant components of the  
3 SIVs' portfolios. S&P's failure to accurately rate these assets was a key reason why the SIVs  
4 ultimately collapsed, and a direct cause of PERS's and other investors' losses when that collapse  
5 occurred.

6                   **C.   S&P Played a Much Larger Role in SIVs Than It Claimed**

7           239.   As set forth above, S&P was deeply involved in structuring SIVs, and advised  
8 them regarding their assets, capital structure, and other matters. This was inconsistent with  
9 S&P's public claim that it "does not act as an investment, financial, or other advisor to, and does  
10 not have a fiduciary relationship with, an issuer or any other person. [S&P] does not become  
11 involved with the actual structuring of any security it rates, and limits its comments to the  
12 potential impact that any structuring proposed by the issuer may have on the rating."

13                   **DEFENDANTS' MISREPRESENTATIONS ABOUT SPECIFIC SECURITIES**  
14                   **PURCHASED BY PERS AND STRS**

15           240.   S&P's misconduct in rating securities did more than render false its  
16 representations about its integrity, independence, expertise, and that it avoided influence by  
17 market share and revenue considerations. That misconduct also infected each of the ratings S&P  
18 issued to the securities purchased by PERS and STRS. S&P had no reason to believe that those  
19 ratings matched S&P's public standards. Indeed, S&P had ample reason to believe the opposite.  
20 And S&P did not in fact believe the ratings of the securities listed in Appendix A to be accurate.  
21 Indeed, the S&P personnel actually creating these ratings – and their senior managers – knew of,  
22 condoned and often referred internally to the corruption of its rating methods with euphemisms  
23 like "massage," "tweaking," "adjusting," "relaxation," "tolerance band," "wing[ing]," "bend,"  
24 "cushion," "random," "arbitrary," and "give and take." Other times, S&P described the  
25 corruption in more vivid terms like "magic numbers," "f\*\*ing scam," "structured by cows,"  
26 "house of cards," "ridiculous," "finger in the air," and "pull it out of thin air."

27           241.   All of the RMBS listed in Appendix A were rated using the versions of LEVELS  
28 in existence between 2004 and 2007. As described above, S&P knew these versions of LEVELS

1 were based on obsolete data and employed "guesses" and "magic numbers." Further, the RMBS  
2 ratings were "massage[d]" to please issuers and compete with Moody's. In fact, LEVELS was so  
3 bad that S&P recognized that its results were little better than a "coin toss." Further, a number of  
4 the RMBS listed on Appendix A were backed by HELs, HELOCs, Alt-A mortgages, ARMs, and  
5 other loans for which S&P knew LEVELS was particularly inaccurate.

6 242. As a result of these and other flaws, S&P could not possibly have thought that, for  
7 example, an AAA rating generated by LEVELS actually meant that an RMBS had an "extremely  
8 strong capacity to meet financial commitments," an AA rating meant an RMBS had a "very  
9 strong capacity to meet financial commitments," and so on. S&P self-evidently did not believe  
10 that these ratings met its published standards.

11 243. S&P's internal evaluation of the accuracy of its RMBS ratings was charitable in  
12 comparison to its views on its ratings of CDOs that went into the SIVs whose securities PERS  
13 purchased. Those ratings were a "f\*\*king scam." The CDO rating process was "a house of  
14 cards" built on "random criteria." The ratings process was corrupted by business considerations  
15 to the point where senior executives admitted that, "it was wrong and I knew it at the time."

16 244. S&P's SIV ratings were compromised not only by the problems with the RMBS  
17 and CDOs the SIVs contained, but also by independent and glaring problems with the SIV rating  
18 models themselves, such as the failure to make any realistic effort to model the actual  
19 performance of a SIV during defeasance.

20 245. All of the ratings listed in Appendix A were therefore false and fraudulent. They  
21 did not represent S&P's true analyses of the creditworthiness of the rated securities. Rather, S&P  
22 issued them with, at best, reckless disregard and deliberate ignorance as to whether the securities  
23 merited the ratings given to them. More likely, S&P knew that the securities did not meet the  
24 standards for their ratings, but intentionally gave inflated ratings to maximize its revenue and  
25 market share.

**PERS AND STRS LOST HUNDREDS OF MILLIONS OF DOLLARS ON STRUCTURED  
FINANCE SECURITIES GIVEN FRAUDULENT RATINGS BY S&P**

246. As described herein, S&P's ratings of structured finance securities were deeply flawed, and S&P knew it.

247. By the second half of 2007, the problems with these securities became too obvious for S&P to ignore. On July 11, 2007 S&P publicly announced that it was placing many non-AAA-rated 2005 and 2006 vintage subprime RMBS on CreditWatch and that large-scale downgrades of these assets would follow. At the same time, S&P announced that it was bolstering its requirements for subprime RMBS rating and surveillance. S&P further announced that it was improving its LEVELS model, and requiring stricter credit protection for deals closing on or after July 10, 2007, among a number of changes to "better mitigate" concerns about its rating methodology going forward.

248. Only one day later, on July 12, 2007, S&P announced a mass downgrade of non-AAA-rated 2005 and 2006 vintage subprime RMBS.

249. In fact, S&P knew that the problems with its ratings were much more widespread. In a July 8, 2007 email, for example, the head of S&P's U.S. RMBS surveillance group stated that "everything that was rated since the 4th quarter of 2005" was suspect. This email responded to another S&P surveillance employee who expressed his surprise that the new issue and criteria group agreed with the ongoing drastic rating changes, then stated that "Alt-A and Prime are next." Further, the head of U.S. RMBS surveillance said that "[d]eals that closed last week (June 30) will also be on cw [Credit Watch]." Investors, such as PERS and STRS, were left in the dark about these broader problems, of course.

250. On October 17, 2007, S&P downgraded 1,713 subprime, Alt-A and closed-end second RMBS rated between January 1, 2007 and June 30, 2007. S&P downgraded the 2007 RMBS because "the same risks that are apparent in the transactions issued in 2006 [were] also present in the 2007 transactions." S&P did not reveal that it had long known that the problems were not limited to 2005 and 2006 subprime RMBS. For example, it continued to hide the facts

1 that its models and criteria for rating non-subprime RMBS (including Alt-A, HELOC, HEL, and  
2 Prime) were defective.

3 251. Key S&P managers and analysts who had participated in the decisions to prevent  
4 the use of adequate RMBS models and criteria from 2004 and after were among the S&P  
5 managers and analysts named on the public announcements of these downgrades, including  
6 Barnes, and Gillis. As a result, even during the period of downgrades between July and October  
7 2007, by concealing the extent of the RMBS rating problems, and delaying rating downgrades,  
8 S&P misled investors into a false sense of security.

9 252. In the ensuing market collapse, PERS and STRS lost hundreds of millions of  
10 dollars on RMBS and SIVs that had been rated AAA by S&P.

### 11 S&P'S MISCONDUCT CONTINUES

12 253. On February 7, 2008, S&P publicly announced that it would take "leadership  
13 actions" to further strengthen the rating process and help restore confidence in the markets  
14 following the financial crisis. At the time of the announcement, S&P President Deven Sharma  
15 represented:

16 The ongoing transformation of the financial markets requires us to continue to  
17 bring more innovative thinking, greater resources, and improved analytics to the  
18 rating process...By further enhancing independence, strengthening the ratings  
19 process, and increasing transparency, the actions we are taking will serve the  
20 public interest by building greater confidence in ratings and supporting the  
21 efficient operation of the global credit markets.

22 254. S&P's "leadership actions" included separating S&P's criteria development  
23 groups from its commercial groups so they would be independent and not influenced by business  
24 concerns, and strengthening criteria on most of the major asset classes.

25 255. On May 8, 2008, S&P hired Mark Adelson – a former vocal critic of rating  
26 agencies – as its Chief Credit Officer to manage the new independent criteria group and supervise  
27 key changes to S&P's rating criteria and methodologies.

28 256. In August 2008, S&P hired David Jacob to manage S&P's Structured Finance  
group, on the commercial rating side of the business, as part of S&P's efforts "to improve  
transparency, build investor confidence, and continue to deliver high-quality, independent

1 analytics." Jacob wanted to "ensure that S&P analysts didn't loosen standards at the request of  
2 bankers." Jacob, like Adelson, had been a critic of rating agency conduct. Prior to joining S&P,  
3 Jacob and Adelson had been partners in a consulting firm.

4 257. In October 2008, S&P President Deven Sharma reaffirmed S&P's promises of  
5 reform to the House Committee on Oversight and Government Reform, testifying that S&P had  
6 taken a number of actions to enhance its rating process and restore the market's confidence in its  
7 ratings following the financial crisis.

8 258. In keeping with his philosophy that rating criteria should be as reliable "as jet  
9 engines on an airplane," Adelson helped revise S&P's rating methodology for CMBS to a more  
10 conservative model that established an "AAA credit enhancement level that would be sufficient to  
11 enable tranches rated at that level to withstand market conditions commensurate with an extreme  
12 economic downturn without defaulting." With the release of the new criteria on June 26, 2009,  
13 the ratings on 1,586 tranches of CMBS transactions were immediately placed on Credit Watch  
14 negative, indicating that the rating may be lowered. After the revised methodology went into  
15 effect, S&P lost CMBS business to its competitors, Moody's and Fitch.

16 259. In September 2009, S&P President Sharma again reaffirmed S&P's promises of  
17 reform in testimony before the House Financial Services Subcommittee, whom he assured that  
18 S&P had learned from the past regarding its ratings on structured finance securities, and that it  
19 had made "major changes" to restore confidence in its ratings. Sharma cited S&P's separation of  
20 its criteria development groups from its commercial groups and other actions taken to avoid  
21 conflicts of interest.

22 260. In December 2010, under Adelson's leadership, S&P published an update that  
23 toughened its methodologies and assumptions for counterparty criteria. Counterparty risk is an  
24 important factor in determining the credit risk of structured finance securities. The updated  
25 criteria were criticized by market participants who contended that they were too onerous.

26 261. Despite the reform efforts by Adelson and Jacob, the emphasis on market share at  
27 the expense of analytics began growing again at S&P. In the spring of 2011, S&P President  
28 Sharma called Jacob and "gave him hell" about loss in business. Jacob explained that the loss



1 was due in part to securities which required counterparty criteria that Adelson had toughened.  
2 Sharma pressured Jacob to do something about it, but Jacob said he was not able to do so because  
3 of the separation between the business and analytical sides at S&P. Sharma was unhappy with  
4 Jacob's response. Following the conversation, Sharma sent an email to Jacob and Paul Coughlin,  
5 S&P's global head of corporates and governments, stating that they needed to consider "changing  
6 direction."

7 262. In June 2011, S&P ratcheted up the pressure on Adelson and Jacob. It brought  
8 them to an S&P leadership meeting organized by Sharma based on the theme: "Relentlessly  
9 Driving Global Growth." Contrary to S&P's public claims that it was "further enhancing [its]  
10 independence," S&P executives were explicitly urged to let issuers influence them. For example,  
11 speakers and meeting materials emphasized that, "Structured finance criteria can easily be  
12 irrelevant if market feedback [is] ignored."

13 263. Meeting materials described S&P's strategy as follows: "Success in criteria  
14 development depends on ongoing collaboration between the criteria group and the business."  
15 Further, "Efforts are underway to improve the current processes and interactions in the  
16 development and dissemination of new criteria. This includes . . . integrating  
17 marketplace/investor viewpoints into the criteria process."

18 264. However, Adelson and Jacob still failed to "collaborate" with issuers or "change  
19 direction" to S&P's satisfaction. In mid-2011 a report by S&P's Structured Finance Department  
20 emphasized that since January 2011, S&P was not asked to rate 13 deals due in part to its  
21 counterparty criteria, and that as a result, S&P lost approximately \$2.275 million in potential  
22 revenue.

23 265. In December 2011, S&P announced Jacob's departure from the company, and  
24 Adelson's removal from his position as Chief Credit Officer.

25 266. In May 2012, S&P's counterparty criteria were made generally more lenient.

26 267. Despite representations by S&P to the contrary, once S&P began to lose market  
27 share to its competitors as a result of toughening its criteria, the promised reforms were rolled  
28 back. S&P executives began to pressure staff to adjust methodologies and assumptions used to

1 rate structured finance securities so that S&P could more easily assign its highest rating and  
2 increase its market share and revenue.

### 3 ACTUAL MALICE

4 268. The law does not require the People to establish that S&P acted with actual malice,  
5 as S&P's false statements as described herein do not enjoy any privileged status under the United  
6 States or California constitutions for multiple reasons. First, S&P's false statements were  
7 commercial speech. Further, S&P's false statements were not statements about any public figures  
8 or matters of public concern within the meaning of the First Amendment. Even if the People  
9 were required to establish actual malice, however, the facts alleged herein show that S&P did in  
10 fact act with actual malice. As shown above, S&P made the false statements alleged herein with  
11 knowledge that they were false or with reckless disregard for whether or not they were true. S&P  
12 did not believe the statements were true, entertained serious doubts as to their truth, or  
13 purposefully avoided the truth regarding their subjects.

14 269. As alleged herein, S&P's false statements were made for the purpose of  
15 promoting, marketing and selling its rating product, and for the purpose of structuring, pricing,  
16 marketing, and promoting the rated securities.

17 270. S&P's ratings were the result of an iterative, consultative process in which the  
18 issuer would describe the ratings it sought and S&P would advise the issuer about what would be  
19 required for S&P to give the security the rating desired by the issuer and provide additional,  
20 related analytic and consultative services.

21 271. All of S&P's ratings were the product of the "issuer pays" model described above,  
22 under which S&P was paid by the issuer to develop and provide its ratings. S&P would not be  
23 paid, or at least would not be paid its full scheduled fee, unless it delivered the ratings desired by  
24 the issuer. S&P had a close relationship with most if not all of the entities involved in issuing the  
25 securities at issue, most or all of whom were repeat customers. As found by Congress in the  
26 Dodd-Frank Wall Street Reform and Consumer Protection Act, S&P's activities as described  
27 herein "are fundamentally commercial in character." (See PL 111-203, 124 Stat 1376, § 931,  
28 subd. (3).)

272. Neither the SIVs nor the trusts or other special purpose entities that issued the RMBS purchased by PERS and STRS were publicly-owned or publicly-traded companies.

273. The ratings at issue in this action were directed to a select group of investors. SIV notes could only be sold, and were necessarily only marketed to, investors who qualified under the federal securities laws as “Qualified Institutional Buyers” and “Qualified Purchasers,” and not to the general investing public. Similarly, RMBS were not marketed or sold to the general public. Rather, they were marketed and sold to a very select group of investors who could afford to purchase securities priced in the tens or hundreds of millions of dollars – generally large institutional investors. Other structured securities at issue in this action, such as CDOs, were marketed and sold to only a similarly select group of investors. Though some or all of the ratings at issue might have been accessible to members of the general investing public who sought them out, the ratings were targeted and sent only to the select groups of investors described, and for the purpose of inducing them to buy the rated securities.

## STATUTES OF LIMITATIONS

274. The People entered into an agreement with S&P tolling the statute of limitations applicable to the People's claims stated herein as of June 15, 2011. The pertinent statutes of limitations are as follows: four years for the Unfair Competition Law claims; three years from the Attorney General's discovery for the False Claims Act claims; and three years from the aggrieved party's or Attorney General's discovery for the False Advertising Law claims.

275. To the extent any of the People's causes of action would otherwise have accrued, or an applicable limitations period(s) have begun to run, before the dates that were three or four years before the tolling agreement effective June 15, 2011 – i.e., before June 15, 2008 or June 15, 2007 – and the People do not concede that any such predicate occurred – the People invoke the common law discovery rule and any other common law doctrines that may apply, including the doctrines of fraudulent concealment and continuous accrual, and in support thereof allege the following.

276. The People did not discover S&P's false, fraudulent, or misleading representations, practices, or advertising (collectively, "fraud") until after June 15, 2008. Neither

1 the People nor the Attorney General knew of S&P's fraud, or knew of facts that would lead a  
2 reasonably prudent person to suspect it, until after June 15, 2008. Prior to June 15, 2008, neither  
3 the People nor the Attorney General had any reasonable means of knowledge or notice which,  
4 followed by an inquiry, would have revealed S&P's fraud by the dates on which the applicable  
5 statutes of limitations might otherwise have begun to run. In particular, the People did not have  
6 knowledge or possession of internal S&P communications that reveal S&P's fraud until well after  
7 June 15, 2008.

8 277. Prior to June 15, 2008, S&P gave repeated, specific, public assurances – including  
9 in two appearances before Congress – that its ratings and ratings processes were objective,  
10 independent, and free from undue influence, and that its rating “opinions” had been genuinely  
11 held. These and other words of comfort from S&P gave false assurance that there was no fraud to  
12 be discovered.

13 278. In addition to the statements by S&P described above regarding the objectivity,  
14 independence, and integrity of its ratings, on April 17, 2007, Susan Barnes, Managing Director  
15 for S&P Ratings Services, testified before the United States Senate Committee on Banking,  
16 Housing, & Urban Affairs, Subcommittee on Securities, Insurance, and Investment, that “S&P  
17 has established an excellent track record of providing the market with independent, objective and  
18 rigorous analytical information and credit rating opinions,” that “S&P conducts its business  
19 grounded in the cornerstone principles of independence, transparency, credibility and quality,”  
20 and that “[t]hese principles have driven our [S&P's] long-standing track record of analytical  
21 excellence and objective commentary.”

22 279. Similarly, in a letter to the editor published in the Wall Street Journal on  
23 September 17, 2007, Vickie Tillman, Executive Vice President for S&P's Credit Market Services,  
24 stated of structured finance transactions that “we rate these deals based on our criteria – criteria  
25 that are publicly available, non-negotiable and consistently applied,” that “[o]ur [S&P's] credit  
26 ratings provide objective, impartial opinions on the credit quality of bonds,” that “[w]e have  
27 institutional safeguards in place to ensure the independence and integrity of these opinions,” and  
28 that while questions had been raised in an article published that month “about the about the

1 independence and integrity of our ratings, citing the potential conflict of interest arising from our  
2 business model[,] [w]e have numerous safeguards in place that have helped us effectively manage  
3 such conflicts.”

4 280. Also, on September 26, 2007, Ms. Tillman testified before the United States  
5 Senate Committee on Banking, Housing, & Urban Affairs that “some have questioned whether  
6 the ‘issuer pays’ model has led S&P and other to issue higher, or less rigorously analyzed, ratings  
7 so as to garner more business. First and foremost, there is no evidence – none at all – to support  
8 this contention with respect to S&P;” that “S&P maintains rigorous policies and procedures  
9 designed to ensure the integrity of our analytical processes;” and that “we do not compromise our  
10 criteria to meet a particular issuer’s goals;” and that S&P had specific policies, some of which  
11 Ms. Tillman described, to ensure the integrity of its rating process and manage potential conflicts  
12 from the issuer-pays model. Also, contrary to what is now known about S&P’s failure to update  
13 its LEVELS model for calculating the default probabilities for loans backing RMBS when it  
14 knew it should have, Ms. Tillman gave the specific words of comfort that, “[t]he assumptions and  
15 analysis embedded in the LEVELS® model are under regular review and are updated as  
16 appropriate to reflect our current thinking about residential mortgages.”

17 **FIRST CAUSE OF ACTION**  
18 **False Claims Act - Government Code § 12651, subd. (a)(I)**  
19 **(Against All Defendants)**

20 281. The People incorporate herein by reference the allegations in paragraphs 1 through  
21 280 of this complaint.

22 282. This is a claim for treble damages, penalties, and costs brought by the People  
23 under the California False Claims Act (“CFCA”), Government Code Sections 12650-12656.

24 283. The terms “knowing” and “knowingly” have the meanings assigned to them in the  
25 CFCA.

26 284. Defendants knowingly caused to be presented to PERS and STRS false or  
27 fraudulent claims for payment or approval for securities including but not limited to the securities  
28 identified in Appendix A to this Complaint. Defendants’ conduct was a substantial factor in  
causing the false claims to be presented. Defendants provided their knowing misrepresentations

1 for the purpose of having them included in the securities' offering materials and offers for sale,  
2 which Defendants intended and knew or should have known would be offered for sale to PERS  
3 and STRS.

4 285. Defendants' misrepresentations had a natural tendency to influence, or were  
5 capable of influencing, PERS's and STRS's decisions to purchase the securities at issue in this  
6 action, and to purchase them on the terms offered, including but not limited to the securities  
7 identified in Appendix A.

8 286. As a proximate result of Defendants' actions, the People suffered damages in a  
9 specific amount to be determined at trial.

10 **SECOND CAUSE OF ACTION**  
11 **False Claims Act - Government Code § 12651, subd. (a)(2)**  
12 **(Against All Defendants)**

13 287. The People incorporate herein by reference the allegations in paragraphs 1 through  
14 286 of this complaint.

15 288. This is a claim for treble damages, penalties, and costs brought by the People  
16 under the California False Claims Act, Government Code Sections 12650-12656 et seq.

17 289. By the same acts described in the People's First Cause of Action, Defendants  
18 knowingly made, used, or caused to be made or used false records or statements to get false  
19 claims paid or approved by PERS and STRS, and knowingly made, used, or caused to be made or  
20 used, false records or statements material to false or fraudulent claims.

21 290. Defendants' misrepresentations, records, or statements had a natural tendency to  
22 influence, or were capable of influencing, PERS's and STRS's decisions to purchase the  
23 securities at issue in this action, and to purchase them on the terms offered, including but not  
24 limited to the securities identified in Appendix A.

25 291. As a proximate result of Defendants' actions, the People suffered damages in a  
26 specific amount to be determined at trial.

**THIRD CAUSE OF ACTION**  
**Business & Professions Code § 17500**  
**(Against All Defendants)**

292. The People incorporate herein by reference the allegations in paragraphs 1 through 291 of this complaint.

293. S&P violated Business & Professions Code section 17500 by publicly making or disseminating untrue or misleading statements, or by causing untrue or misleading statements to be made or disseminated to the public, in or from California, with the intent to induce members of the public and investors to purchase S&P's ratings services and rely on its ratings of structured finance securities and/or to purchase structured finance securities rated by S&P. These untrue and misleading statements include but are not necessarily limited to:

(a) Statements that S&P's ratings of structured finance securities were independent, objective, and not influenced by its desire for revenue or pleasing issuers to gain their business or win additional business;

(b) Statements that S&P dealt fairly and honestly with the public, including the investors of the structured finance securities that it rated;

(c) Statements that S&P acknowledged and managed the conflict of interest inherent in the issuer-pays model;

(d) Statements that S&P adhered to stated criteria in assigning a credit rating and conducting ongoing surveillance to ensure that rated securities continue to reflect the assigned credit rating; and

(e) Statements regarding the ratings of thousands of specific securities.

294. Defendants knew, or by the exercise of reasonable care should have known, that their statements were untrue or misleading at the time they made them and at the time they rated structured finance securities during the relevant period alleged in this complaint.

**FOURTH CAUSE OF ACTION**  
**Unfair Competition - Business and Professions Code § 17200**  
**(Against All Defendants)**

295. The People incorporate herein by reference the allegations in paragraphs 1 through 294 of this complaint.

296. Defendants have engaged in, and continue to engage in, unlawful, fraudulent, or unfair acts or practices in the conduct of a business, which acts or practices constitute unfair competition, as that term is defined in Business and Professions Code section 17200. Such acts or practices include, but are not limited to, the following:

(a) Issuing ratings that were not independent, were not objective or credible, and were influenced by their desire for revenue or pleasing issuers to gain their business or win additional business;

(b) Failing to deal fairly and honestly with investors, including the investors of the structured finance securities that they rate;

(c) Failing to manage the conflict of interest inherent in the issuer-pays model;

(d) Violating Business and Professions Code section 17500, as described in the Fourth Cause of Action, above; and

(e) Violating Government Code section 12651, as described in the First and Second Causes of Action, above.

#### PRAYER FOR RELIEF

1. Wherefore, Plaintiff, the People, pray for relief against all Defendants as follows:

2. Pursuant to Government Code Section 12651 subdivision (a), three times the damages which PERS and STRS sustained as a result of Defendants' false claims in an amount to be determined.

3. Pursuant to Government Code Section 12651, subdivision (a), the maximum allowed Civil penalties for each false claim.

4. Pursuant to Business and Professions Code section 17536, that Defendants, and each of them, be ordered to pay a civil penalty in the amount of \$2,500 for each violation of Business and Professions Code section 17500 by Defendants, in an amount according to proof.

5. Pursuant to Business and Professions Code section 17206, that Defendants, and each of them, be ordered to pay a civil penalty in the amount of \$2,500 for each violation of Business and Professions Code section 17200 by Defendants, in an amount according to proof.



1           6. Pursuant to Business and Professions Code sections 17203 and 17535, that  
2 Defendants, and each of them, be enjoined from engaging in violations of the California Unfair  
3 Competition Law and the California False Advertising Law, including without limitation the  
4 unfair, unlawful, and deceptive practices alleged herein.

5           7. That the Court make such orders or judgments as may be necessary to restore to  
6 any person in interest any money or property, real or personal, which may have been acquired by  
7 means of unfair competition, under the authority of Business and Professions Code section 17203.

8           8. That the Court make such orders or judgments as may be necessary to restore to  
9 any person in interest any money or property, real or personal, which may have been acquired by  
10 means of any practice declared to be unlawful by Business and Professions Code section 17500 et  
11 seq., under the authority of Business and Professions Code section 17535.

12           9. That the People recover their costs of suit, including costs of investigation.

13           10. Such further or additional relief as the Court deems proper.

14  
15 Dated: February 5, 2013

Respectfully Submitted,

KAMALA D. HARRIS  
Attorney General of California  
MARTIN GOYETTE  
Senior Assistant Attorney General



FREDERICK W. ACKER  
Deputy Attorney General  
*Attorneys for the People of the State of  
California*

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## APPENDIX A

### CalPERS Losses on Sale on RMBS Rated by S&P

SECURITY DESCRIPTION	CUSIP	TRADE DATE	S&P RATING AT TIME OF PURCHASE	LOSS ON SALE
CWALT 2007-20 A12	02151LAM8	8/23/2007	AAA	-\$57,640,787.23
PRIME 2007-3 1A1	74162WAA6	8/14/2007	AAA	-\$40,116,227.74
SVHE 2007-1 2A1	83612PAB6	2/23/2007	AAA	-\$36,308,491.25
WASI 2007-HE1 A	92976YAA0	3/16/2007	AAA	-\$31,595,791.80
AHM 2005-1 7A1	02660TDJ9	3/29/2005	AAA	-\$25,950,497.65
BSARM 2005-7 1A1	07387ACX1	8/5/2005	AAA	-\$20,571,725.79
CWALT 2007-23CB A1	02151EAA0	8/8/2007	AAA	-\$20,112,603.02
MSAC 2007-NC4 A2A	61755EAB4	6/15/2007	AAA	-\$19,581,057.96
CWHL 2006-1 A2	126694XC7	1/27/2006	AAA	-\$16,850,107.41
RALI 2005-QA4 A31	76110H4J5	3/30/2005	AAA	-\$15,884,634.29
WMHE 2007-HE2 2A1	92926SAB2	4/4/2007	AAA	-\$14,360,036.63
MSHLC 2007-1 A	55352RAA6	2/22/2007	AAA	-\$12,432,241.37
GSR 2006-1F 5A1	3623417Z6	1/25/2006	AAA	-\$11,225,669.66
RAMC 2007-3 AF1	75971FAD5	8/31/2007	AAA	-\$10,544,905.33
CMLTI 2007-AMC2 A3A	17311XAA3	2/15/2007	AAA	-\$9,627,653.72
CWL 2007-S1 A1A	12669RAA5	2/23/2007	AAA	-\$8,943,152.05
WMALT 2007-HY1 A1	93936AAA9	1/19/2007	AAA	-\$8,898,642.25
RALI 2005-QA4 A41	76110H4L0	3/30/2005	AAA	-\$8,671,543.11
CBASS 2007-CB1 AF1A	1248MGAJ3	1/26/2007	AAA	-\$8,416,043.45
CWL 2006-S8 A1	12668XAA3	12/7/2006	AAA	-\$6,589,122.49
CWHEL 2007-B A	12669XAE4	3/19/2007	AAA	-\$6,469,026.12

LBAHC 2006-11 N1	92933KAA2	12/19/2006	A-	-\$6,436,345.43
ELAT 2007-2 A2A	288547AB8	10/4/2007	AAA	-\$9,553,364.46
FFMER 2007-4 2A1	59025CAB6	6/18/2007	AAA	-\$6,089,210.34
FFMER 2007-3 A2A	59024VAE9	5/23/2007	AAA	-\$5,880,102.82
CWL 2007-S1 A1A	12669RAA5	2/23/2007	AAA	-\$5,809,308.97
WFMBS 2005-8 A1	94982VAA4	9/8/2005	AAA	-\$5,786,831.58
RAMC 2007-3 AF1	75971FAD5	8/31/2007	AAA	-\$5,767,853.61
CWL 2007-S2 A1	12670BAA7	3/23/2007	AAA	-\$5,740,876.78
SAST 2007-3 2A1	80557BAB0	7/27/2007	AAA	-\$5,666,277.28
CWHL 2005-HYB2 2A	12669GWU1	3/30/2005	AAA	-\$5,428,403.57
MSM 2007-6XS 2A1S	61751JAF8	3/16/2007	AAA	-\$5,311,539.96
WMHE 2007-HE1 2A1	933631AB9	1/11/2007	AAA	-\$5,248,896.06
WFMBS 2005-8 A1	94982VAA4	9/8/2005	AAA	-\$5,036,056.31
FHABS 2007-HE1 A	32053JAA5	6/19/2007	AAA	-\$4,987,911.67
WFMBS 2004-2 A1	949800AA4	2/9/2004	AAA	-\$4,258,541.73
ACE 2007-HE1 A2A	00443LAB4	1/26/2007	AAA	-\$3,721,655.01
FMIC 2006-3 2A1	316599AB5	10/20/2006	AAA	-\$3,218,486.09
FFMER 2007-2 A2A	59024QAB6	4/16/2007	AAA	-\$3,190,980.74
CWL 2007-12 2A1	126697AC5	8/17/2007	AAA	-\$3,169,444.90
BOAMS 2005-L 4A1	05949CPP5	12/22/2005	AAA	-\$3,151,086.93
FHABS 2006-HE2 A	32052XAA5	11/15/2006	AAA	-\$3,117,465.48
BAFC 2006-1 2A1	05949TBD0	1/19/2006	AAA	-\$3,062,564.67
FHASI 2005-AR6 4A1	32051GJ89	12/7/2005	AAA	-\$2,964,692.70
SARM 2004-16 5A3	863579EU8	10/26/2004	BBB+	-\$2,936,197.06
MSM 2006-15XS A1	61750YAA7	10/18/2006	AAA	-\$2,851,730.17

FFMER 2007-5 2A1	59025RAT4	9/25/2007	AAA	-\$2,408,406.46
JPMAC 2007-CH4 A2	46630CAB0	6/7/2007	AAA	-\$2,256,568.20
BOAMS 2005-L 4A1	05949CPP5	12/22/2005	AAA	-\$1,975,734.14
NSTR 2007-C 2AV1	63860KAB8	5/23/2007	AAA	-\$1,815,401.78
MABS 2007-HE2 A2	57646LAA1	8/24/2007	AAA	-\$1,757,542.30
MSM 2006-15XS A1	61750YAA7	10/18/2006	AAA	-\$1,604,098.22
CMSI 2004-1 3A1	172973VQ9	1/28/2004	AAA	-\$1,536,081.43
BAFC 2005-G A1	05946XB85	9/16/2005	AAA	-\$1,409,405.80
CWL 2007-3 2A1	12668UAE1	3/16/2007	AAA	-\$1,396,871.43
CMLTI 2004-HYB2 3A	17307GED6	4/15/2004	AAA	-\$1,154,449.63
ACE 2007-HE1 A2A	00443LAB4	1/26/2007	AAA	-\$1,132,677.61
JPMAC 2007-CH3 A2	46630XAC2	5/3/2007	AAA	-\$1,032,399.57
SVHE 2007-NS1 A1	83612QAA6	3/2/2007	AAA	-\$931,070.91
FFML 2007-FF1 A2A	32028TAB3	1/22/2007	AAA	-\$897,746.30
BOAMS 2004-3 4A1	05949ACB4	3/3/2004	AAA	-\$886,696.93
SAST 2007-2 A2A	80556YAB1	4/18/2007	AAA	-\$885,529.74
FFML 2007-FF2 A2A	32029GAB0	2/23/2007	AAA	-\$726,625.08
CWL 2007-1 2A1	23245CAB6	1/26/2007	AAA	-\$705,113.65
RAMP 2004-SL1 A7	760985W80	3/17/2004	AA-	-\$467,185.38
BAFC 2006-2 3A1	05949QBE4	1/31/2006	AAA	-\$387,478.92
RAMP 2004-SL1 A8	760985W98	3/17/2004	AA-	-\$369,895.08
BOAMS 2004-5 4A1	05948X7Q8	7/8/2004	AAA	-\$356,465.93
BSARM 2004-2 14A	07384MM66	4/21/2004	AAA	-\$354,726.78
OOMLT 2007-2 3A1	68401TAC2	3/2/2007	AAA	-\$334,954.74
OOMLT 2007-3 2A1	68402BAB2	3/30/2007	AAA	-\$331,950.68

BAFC 2004-C 1A1	05946XLS0	11/10/2004	AAA	-\$328,827.01
BOAMS 2004-3 3A2	05949ABZ2	3/23/2004	BBB	-\$328,033.12
OOMLT 2007-5 2A1	68403HAB8	4/19/2007	AAA	-\$286,022.66
JPMAC 2006-CH2 AV2	46629QAT3	11/21/2006	AAA	-\$279,139.81
BOAMS 2005-H 4A2	05949CGE0	8/10/2005	AAA	-\$240,469.11
RASC 2007-KS3 AI1	74924YAA1	3/26/2007	AAA	-\$170,473.19
JPMAC 2006-CH2 AF1A	46629QAA4	11/21/2006	AAA	-\$112,565.33
CWL 2006-S5 A1	126683AA9	9/15/2006	AAA	-\$72,430.59

**Total = -\$538,108,822.13**

### CalPERS Realized Losses on SIV Securities Rated by S&P

SECURITY DESCRIPTION	CUSIP	PURCHASE DATE	S&P RATING AT TIME OF PURCHASE	REALIZED LOSSES
CHEYNE	16705EAV5	2/10/2006	AAA/A-1+	-\$199,700,000.00
	16705EAX1	2/16/2006	AAA/A-1+	
	16705EBN2	4/20/2006	AAA/A-1+	
	16705ECK7	9/21/2006	AAA/A-1+	
	16705EDA8	11/1/2006	AAA/A-1+	
STANFIELD VICTORIA	85431AFE2	2/16/2006	AAA/A-1+	-\$354,200,000.00
	85431AFA0	2/16/2006	AAA/A-1+	
	85431AFC6	2/16/2006	AAA/A-1+	
	85431AFD4	2/16/2006	AAA/A-1+	
	85431AFF9	3/9/2006	AAA/A-1+	
	85431ADP9	8/4/2006	AAA/A-1+	
	85431ADT1	8/4/2006	AAA/A-1+	
	85431AHA8	9/8/2006	AAA/A-1+	
	85431AHV2	10/26/2006	AAA/A-1+	
SIGMA	8265Q0TF9	9/26/2006	AAA/A-1+	-\$225,000,000.00
	8265Q0TM4	10/13/2006	AAA/A-1+	
	8265Q0WL2	3/29/2007	AAA/A-1+	

**Grand Total = -\$778,900,000.00**

### CalSTRS Losses on Sale on RMBS Rated by S&P

SECURITY DESCRIPTION	CUSIP	TRADE DATE	S&P RATING AT TIME OF PURCHASE	LOSS ON SALE
BSALTA 2006-8_II-A-2	07387QAN0	5/22/2007	AAA	-\$14,820,511.24
CWL 2006-11_1AF-4	12666TAD8	9/6/2006	AAA	-\$5,635,950.79
CWL 2006-S3_A3	23242MAC5	8/25/2006	AAA	-\$3,667,248.71
GMACM2007-HE2_A4	36186LAD5	6/27/2007	AAA	-\$2,767,575.26
NAA 2005-AP3_A3	65535VPD4	2/5/2007	AAA	-\$2,618,512.27
CBASS 2007-CB2_A2E	1248MBAL9	2/27/2007	AAA	-\$2,562,974.54
CMLTI 2007-AR5_1A1A	17311LAA9	5/22/2007	AAA	-\$1,939,962.84
NAA 2007-1_IA3	65538PAD0	5/8/2007	AAA	-\$1,882,504.33
CWL 2005-11_AF-4	126670CJ5	8/1/2006	AAA	-\$1,873,934.92
CWL 2007-S2_A4F	12670BAD1	3/26/2007	AAA	-\$1,677,218.74

**Total = -\$39,446,393.64**